MICROSOFT CORP
Form 10-K
July 26, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended June 30, 2012

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From to

Commission File Number 0-14278

MICROSOFT CORPORATION

WASHINGTON	**91-1144442**
(STATE OF INCORPORATION)	**(I.R.S. ID)**

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

(425) 882-8080

www.microsoft.com/investor

Securities registered pursuant to Section 12(b) of the Act:

COMMON STOCK, $0.00000625 par value per share	**NASDAQ**

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of December 31, 2011, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $195,333,665,376 based on the closing sale price as reported on the NASDAQ National Market System. As of July 18, 2012, there were 8,383,396,575 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held on November 28, 2012 are incorporated by reference into Part III.

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FORM 10-K

For The Fiscal Year Ended June 30, 2012

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Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including without limitation, the following sections: Business, Management s Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, will likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled Risk Factors (Part I, Item 1A of this Form 10-K). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

PART I

ITEM 1. BUSINESS

GENERAL

Microsoft was founded in 1975. Our mission is to enable people and businesses throughout the world to realize their full potential by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and hardware that deliver new opportunities, greater convenience, and enhanced value to people s lives. We do business worldwide and have offices in more than 100 countries.

We generate revenue by developing, licensing, and supporting a wide range of software products and services, by designing and selling hardware, and by delivering relevant online advertising to a global customer audience. In addition to selling individual products and services, we offer suites of products and services.

Our products include operating systems for personal computers (PCs), servers, phones, and other intelligent devices; server applications for distributed computing environments; productivity applications; business solution applications; desktop and server management tools; software development tools; video games; and online advertising. We also design and sell hardware including the Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 accessories, and Microsoft PC hardware products.

We provide consulting and product and solution support services, and we train and certify computer system integrators and developers. We also offer cloud-based solutions that provide customers with software, services and content over the Internet by way of shared computing resources located in centralized data centers. Cloud revenue is earned primarily from usage fees and advertising.

Examples of cloud-based computing services we offer include:

Microsoft Office 365, an online suite that enables people to work from virtually anywhere at any time with simple, familiar collaboration and communication solutions, including Microsoft Office, Exchange, SharePoint, and Lync;

Xbox LIVE service, which enables online gaming, social networking, and access to a wide range of video, gaming, and entertainment content;

Microsoft Dynamics CRM Online customer relationship management services for sales, service, and marketing professionals provided through a familiar Microsoft Outlook interface;

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- Bing, our Internet search engine that finds and organizes the answers people need so they can make faster, more informed decisions;

- Skype, which allows users to connect with friends, family, clients, and colleagues through a variety of devices; and

- the Azure family of platform and database services that helps developers connect applications and services in the cloud or on premise. These services include Windows Azure, a scalable operating system with computing, storage, hosting, and management capabilities, and Microsoft SQL Azure, a relational database.

We also conduct research and develop advanced technologies for future software and hardware products and services. We believe that we will continue to grow and meet our customers needs by delivering compelling, new, high-value solutions through our integrated software, hardware, and services platforms, creating new opportunities for partners, improving customer satisfaction, and improving our service excellence, business efficacy, and internal processes.

OPERATING SEGMENTS

We operate our business in five segments: Windows & Windows Live Division, Server and Tools, Online Services Division, Microsoft Business Division, and Entertainment and Devices Division. Our segments provide management with a comprehensive financial view of our key businesses. The segments enable the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and they provide a framework for timely and rational allocation of development, sales, marketing, and services resources within businesses. Additional information on our operating segments and geographic and product information is contained in Note 21 Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

Windows & Windows Live Division

Windows & Windows Live Division (Windows Division) develops and markets PC operating systems, related software and online services, and PC hardware products. This collection of software, hardware, and services is designed to empower individuals, companies, and organizations and simplify everyday tasks through seamless operations across the user s hardware and software and efficient Web browsing. User demand for mobility is increasing; as a result, we are working to increase the number of scenarios and devices that Windows enables.

Windows Division revenue growth is largely correlated to the growth of the PC market worldwide, as approximately 75% of total Windows Division revenue comes from Windows operating system software purchased by original equipment manufacturers (OEMs), which they pre-install on equipment they sell. In addition to PC market volume changes, Windows revenue is impacted by:

- PC market changes driven by shifts between developed markets and emerging markets, consumer PCs and business PCs, and among varying forms of computing devices;

- the attachment of Windows to PCs shipped and changes in inventory levels within the OEM channel; and

- pricing changes and promotions, pricing variation that occurs when the mix of PCs manufactured shifts from local and regional system builders to large, multinational OEMs, and different pricing of Windows versions licensed.

***Principal Products and Services*:** Windows 7 operating system; Windows Live suite of applications and web services; and PC hardware products.

The next version of our operating system, Windows 8, will be generally available on October 26, 2012. At that time, we will begin selling the Surface, a series of Microsoft-designed and manufactured hardware devices.

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The Windows operating system faces competition from various commercial software products and from alternative platforms and devices, mainly from Apple and Google. We believe Windows competes effectively by giving customers choice, value, flexibility, security, an easy-to-use interface, compatibility with a broad range of hardware and software applications, including those that enable productivity, and the largest support network for any operating system. Additionally, Windows 8 will run on both x86 and ARM architecture, enabling an even wider range of devices that run Windows. The Windows 8 operating system will include the Windows Store, an online application marketplace. This marketplace will benefit our developer and partner ecosystems by providing access to a large customer base and will benefit Windows users by providing centralized access to certified applications.

Windows Live software and services compete with similar software and service products from Apple, Google, Yahoo!, and a wide array of websites and portals that provide communication and sharing tools and services.

Our PC hardware products face competition from computer and other hardware manufacturers, many of which are also current or potential partners.

Server and Tools

Server and Tools develops and markets server software, software developer tools, services, and solutions that are designed to make information technology professionals and developers and their systems more productive and efficient. Server software is integrated server infrastructure and middleware designed to support software applications built on the Windows Server operating system. This includes the server platform, database, business intelligence, storage, management and operations, virtualization, service-oriented architecture platform, security and identity software. Server and Tools also builds standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Server offerings can be run on-site, in a partner-hosted environment, or in a Microsoft-hosted environment.

Our cloud-based services comprise a scalable operating system with computing, storage, management, and database capabilities, from which customers can run enterprise workloads and web applications. These services also include a platform that helps developers connect applications and services in the cloud or on premise. Our goal is to enable customers to devote more resources to development and use of applications that benefit their businesses, rather than managing on-premises hardware and software. We are unique in our ability to provide customers hybrid solutions that bring together the benefits of traditional on-site offerings with cloud-based services.

Server and Tools offers a broad range of enterprise consulting and product support services (Enterprise Services) that assist customers in developing, deploying, and managing Microsoft server and desktop solutions. In addition, Windows Embedded extends the power of Windows and the cloud to intelligent systems by delivering specialized operating systems, tools, and services. Server and Tools also provides training and certification to developers and information technology professionals for our Server and Tools, Microsoft Business Division, and Windows & Windows Live Division products and services.

Approximately 55% of Server and Tools revenue comes primarily from multi-year volume licensing agreements, approximately 25% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

***Principal Products and Services*:** Windows Server operating systems; Windows Azure; Microsoft SQL Server; SQL Azure; Windows Intune; Windows Embedded; Visual Studio; Silverlight; System Center products; Microsoft Consulting Services; and Premier product support services.

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Our server operating system products face competition from a wide variety of server operating systems and applications offered by companies with a range of market approaches. Vertically integrated computer manufacturers such as Hewlett-Packard, IBM, and Oracle offer their own versions of the Unix operating system preinstalled on server hardware. Nearly all computer manufacturers offer server hardware for the Linux operating system and many contribute to Linux operating system development. The competitive position of Linux has also benefited from the large number of compatible applications now produced by many commercial and non-commercial software developers. A number of companies, such as Red Hat, supply versions of Linux.

We compete to provide enterprise-wide computing solutions and point solutions with numerous commercial software vendors that offer solutions and middleware technology platforms, software applications for connectivity (both Internet and intranet), security, hosting, database, and e-business servers. IBM and Oracle lead a group of companies focused on the Java Platform Enterprise Edition that compete with our enterprise-wide computing solutions. Commercial competitors for our server applications for PC-based distributed client/server environments include CA Technologies, IBM, and Oracle. Our Web application platform software competes with open source software such as Apache, Linux, MySQL, and PHP. In middleware, we compete against Java middleware such as Geronimo, JBoss, and Spring Framework.

Our system management solutions compete with server management and server virtualization platform providers, such as BMC, CA Technologies, Hewlett-Packard, IBM, and VMware. Our database, business intelligence, and data warehousing solutions offerings compete with products from IBM, Oracle, SAP, and other companies. Our products for software developers compete against offerings from Adobe, IBM, Oracle, other companies, and open-source projects, including Eclipse (sponsored by CA Technologies, IBM, Oracle, and SAP), PHP, and Ruby on Rails, among others.

Our embedded systems compete in a highly fragmented environment in which key competitors include IBM, Intel, and versions of embeddable Linux from commercial Linux vendors such as Metrowerks and MontaVista Software.

Our cloud-based services face diverse competition from companies such as Amazon, Google, Salesforce.com, and VMware. SQL Azure specifically faces competition from IBM, Oracle, and other open source offerings. The Enterprise Services business competes with a number of diverse companies, including multinational consulting firms and small niche businesses focused on specific technologies.

We believe our server products, cloud-based services, and Enterprise Services provide customers with advantages in performance, total costs of ownership, and productivity by delivering superior applications, development tools, compatibility with a broad base of hardware and software applications, security, and manageability.

Online Services Division

Online Services Division (OSD) develops and markets information and content designed to help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. OSD offerings include Bing, MSN, adCenter, and advertiser tools. Bing and MSN generate revenue through the sale of search and display advertising, accounting for nearly all of OSD s annual revenue. Expanding Bing beyond a standalone consumer search engine, we continue to expand our use of Bing s technology by integrating the platform into other Microsoft products, including Xbox 360 and Windows Phone, to enhance those offerings.

In December 2009, we entered into an agreement with Yahoo! to provide the exclusive algorithmic and paid search platform for Yahoo! websites worldwide. We have completed the worldwide algorithmic transition and the paid search transition in the U.S., Canada, U.K., France, Germany, and several other markets, and are transitioning paid search in the remaining international markets. We believe this agreement is allowing us to improve the effectiveness and increase the relevance of our search offering through greater scale in search queries and an expanded and more competitive search and advertising marketplace.

***Principal Products and Services*:** Bing; MSN; adCenter; and Atlas online tools for advertisers.

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OSD competes with Google and a wide array of websites and portals that provide content and online offerings to end users. Our success depends on our ability to attract new users, understand intent, and match intent with relevant content and advertiser offerings. We believe we can attract new users by continuing to offer new and compelling products and services and to further differentiate our offerings by providing a broad selection of content and by helping users make faster, more informed decisions and take action more quickly by providing relevant search results, expanded search services, and deeply-integrated social recommendations.

Microsoft Business Division

Microsoft Business Division (MBD) offerings consist of the Microsoft Office system (comprising mainly Office, Office 365, SharePoint, Exchange, and Lync) and Microsoft Dynamics business solutions, which may be delivered either on premise or as a cloud-based service. The Microsoft Office system is designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions and generates over 90% of MBD revenue. Growth in Office depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other areas such as content management, enterprise search, collaboration, unified communications, and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management (CRM), supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises.

Approximately 80% of MBD revenue is generated from sales to businesses, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue. Revenue from sales to businesses generally depends upon the number of information workers in a licensed enterprise and is therefore relatively independent of the number of PCs sold in a given year. Approximately 20% of MBD revenue is derived from sales to consumers, which includes revenue from retail packaged product sales and OEM revenue. This revenue generally is affected by the level of PC shipments and by product launches.

***Principal Products and Services*:** Microsoft Office; Microsoft Exchange; Microsoft SharePoint; Microsoft Lync; Microsoft Office Project and Office Visio; Microsoft Dynamics ERP and Dynamics CRM; Microsoft Office 365, which is an online services offering of Microsoft Office, Exchange, SharePoint, and Lync; and Microsoft Office Web Apps, which are the online companions to Microsoft Word, Excel, PowerPoint, and OneNote.

Competition

Competitors to the Microsoft Office system include software application vendors such as Adobe, Apple, Cisco, Google, IBM, Oracle, SAP, and numerous Web-based competitors as well as local application developers in Asia and Europe. Apple distributes versions of its application software products with various models of its PCs and through its mobile devices. Cisco is using its position in enterprise communications equipment to grow its unified communications business. IBM has a measurable installed base with its office productivity products. Google provides a hosted messaging and productivity suite that competes with the Microsoft Office system. Web-based offerings competing with individual applications can also position themselves as alternatives to Microsoft Office system products. We believe our products compete effectively based on our strategy of providing powerful, flexible, secure, easy to use solutions that work well with technologies our customers already have and are available on a device or via the cloud.

Our Microsoft Dynamics products compete with vendors such as Oracle and SAP in the market for large organizations and divisions of global enterprises. In the market focused on providing solutions for small and mid-sized businesses, our Microsoft Dynamics products compete with vendors such as Infor and Sage. Additionally, Salesforce.com s on-demand CRM offerings compete directly with Microsoft Dynamics CRM Online and Microsoft Dynamics CRM s on-premise offerings.

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Entertainment and Devices Division

Entertainment and Devices Division (EDD) develops and markets products and services designed to entertain and connect people. The Xbox 360 entertainment platform, including Kinect, is designed to provide a unique variety of entertainment choices through the use of our devices, peripherals, content, and online services. Skype is designed to connect friends, family, clients, and colleagues through a variety of devices. Windows Phone is designed to bring users closer to the people, applications, and content they need, while providing unique capabilities such as Microsoft Office and Xbox LIVE. Through a strategic alliance, Windows Phone and Nokia are jointly creating new mobile products and services and extending established product and services to new markets.

Principal Products and Services: Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 video games, Xbox 360 accessories; Xbox LIVE; Skype; and Windows Phone.

Competition

Entertainment and devices businesses are highly competitive, characterized by rapid product life cycles, frequent introductions of new products and game titles, and the development of new technologies. The markets for our products are characterized by significant price competition, and we anticipate continued pricing pressure from our competitors. Our competitors vary in size from very small companies with limited resources to very large, diversified corporations with substantial financial and marketing resources. We compete primarily on the basis of product quality and variety, timing of product releases, and effectiveness of distribution and marketing.

Our Xbox gaming and entertainment business competes with console platforms from Nintendo and Sony, both of which have a large, established base of customers. The lifecycle for gaming and entertainment consoles averages five to 10 years. We released Xbox 360, our second generation console, in November 2005. Nintendo and Sony released new versions of their game consoles in late 2006. We believe the success of gaming and entertainment consoles is determined by the availability of games for the console, providing exclusive game content that gamers seek, the computational power and reliability of the console, and the ability to create new experiences via online services, downloadable content, and peripherals. In addition to Nintendo and Sony, our businesses compete with both Apple and Google in offering content products and services to the consumer. We believe the Xbox 360 entertainment platform is positioned well against competitive products and services based on significant innovation in hardware architecture, user interface, developer tools, online gaming and entertainment services, and continued strong exclusive content from our own game franchises as well as other digital content offerings.

Windows Phone faces competition primarily from Apple, Google, and Research In Motion. Skype competes primarily with Apple and Google, which offer a selection of instant messaging, voice, and video communication products.

OPERATIONS

We have operations centers that support all operations in their regions, including customer contract and order processing, credit and collections, information processing, and vendor management and logistics. The regional center in Ireland supports the European, Middle Eastern, and African region; the center in Singapore supports the Japan, India, Greater China, and Asia-Pacific region; and the centers in Fargo, North Dakota, Fort Lauderdale, Florida, Puerto Rico, Redmond, Washington, and Reno, Nevada support Latin America and North America. In addition to the operations centers, we also operate data centers throughout the Americas, Europe, and Asia regions.

To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we localize many of our products to reflect local languages and conventions. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

We contract most of our manufacturing activities for Xbox 360 and related games, Kinect for Xbox 360, various retail software packaged products, Surface devices, and Microsoft PC hardware to third parties. Our products may include some components that are available from only one or limited sources. Our Xbox 360 console and Kinect for Xbox

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360 include key components that are supplied by a single source. The integrated central processing unit/graphics processing unit is purchased from IBM, and the supporting embedded dynamic random access memory chips are purchased from Taiwan Semiconductor Manufacturing Company. Sole source suppliers also will produce key components of our Surface devices. We generally have the ability to use other manufacturers if the current vendor becomes unavailable or unable to meet our requirements. We generally have multiple sources for raw materials, supplies, and components, and are often able to acquire component parts and materials on a volume discount basis.

RESEARCH AND DEVELOPMENT

During fiscal years 2012, 2011, and 2010, research and development expense was $9.8 billion, $9.0 billion, and $8.7 billion, respectively. These amounts represented 13%, 13%, and 14%, respectively, of revenue in each of those years. We plan to continue to make significant investments in a broad range of research and development efforts.

Product Development and Intellectual Property

We develop most of our software products and services internally. Internal development allows us to maintain competitive advantages that come from closer technical control over our products and services. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. We strive to obtain information as early as possible about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing. Generally, we also create product documentation internally.

We protect our intellectual property investments in a variety of ways. We work actively in the U.S. and internationally to ensure the enforcement of copyright, trademark, trade secret, and other protections that apply to our software and hardware products, services, business plans, and branding. We are a leader among technology companies in pursuing patents and currently have a portfolio of over 31,000 U.S. and international patents issued and over 38,000 pending. While we employ much of our internally developed intellectual property exclusively in Microsoft products and services, we also engage in outbound and inbound licensing of specific patented technologies that are incorporated into licensees or Microsoft s products. From time to time, we enter into broader cross-license agreements with other technology companies covering entire groups of patents. We also purchase or license technology that we incorporate into our products or services.

While it may be necessary in the future to seek or renew licenses relating to various aspects of our products and business methods, we believe, based upon past experience and industry practice, such licenses generally could be obtained on commercially reasonable terms. We believe our continuing research and product development are not materially dependent on any single license or other agreement with a third party relating to the development of our products.

Investing in the Future

Microsoft s success is based on our ability to create new and compelling products, services, and experiences for our users, initiate and embrace disruptive technology trends, to enter new geographic and product markets, and to drive broad adoption of our products and services. We invest in a range of emerging technology trends and breakthroughs that we believe offer significant opportunities to deliver value to our customers and growth for the company. We maintain our long-term commitment to research and development across a wide spectrum of technologies, tools, and platforms spanning communication and collaboration, information access and organization, entertainment, business and e-commerce, advertising, and devices.

While our main research and development facilities are located in Redmond, Washington, we also operate research and development facilities in other parts of the U.S. and around the world, including Canada, China, Denmark, Estonia, Germany, India, Ireland, Israel, and the United Kingdom. This global approach helps us remain competitive in local markets and enables us to continue to attract top talent from across the world. We generally fund research at

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the corporate level to ensure that we are looking beyond immediate product considerations to opportunities further in the future. We also fund research and development activities at the business segment level. Much of our business segment level research and development is coordinated with other segments and leveraged across the company.

In addition to our main research and development operations, we also operate Microsoft Research. Microsoft Research is one of the world s largest computer science research organizations, and works in close collaboration with top universities around the world to advance the state-of-the-art in computer science, providing us a unique perspective on future technology trends.

Based on our assessment of key technology trends and our broad focus on long-term research and development, we see significant opportunities to drive future growth in smart connected devices, cloud computing, entertainment, search, communications, and productivity.

DISTRIBUTION, SALES, AND MARKETING

We market and distribute our products and services primarily through the following channels: OEM; distributors and resellers; and online.

OEM

We distribute software through OEMs that pre-install our software on new PCs, servers, smartphones, and other intelligent devices that they sell to end customers. The largest component of the OEM business is the Windows operating system pre-installed on PCs. OEMs also sell hardware pre-installed with other Microsoft products, including server and embedded operating systems and applications such as our Microsoft Office suite. In addition to these products, we also market through OEMs software services such as our Windows Live Essentials suite.

There are two broad categories of OEMs. The largest OEMs, many of which operate globally, are referred to as Direct OEMs, as our relationship with them is managed through a direct agreement between Microsoft and the manufacturer. We have distribution agreements covering one or more of our products with virtually all of the multinational OEMs, including Acer, ASUS, Dell, Fujitsu, HTC, Hewlett-Packard, LG, Lenovo, Nokia, Samsung, Sony, Toshiba, and with many regional and local OEMs. The second broad category of OEMs consists of lower-volume PC manufacturers (also called system builders), which source their Microsoft software for pre-installation and local redistribution primarily through the Microsoft distributor channel rather than through a direct agreement or relationship with Microsoft. Some of the distributors in the Microsoft distributor channel are global, such as Ingram Micro and Tech Data, but most operate at a local or regional level.

Distributors and Resellers

Many organizations that license our products and services through enterprise agreements transact directly with us, with sales support from solution integrators, independent software vendors, web agencies, and developers that advise organizations on licensing our products and services (Enterprise Software Advisors). Organizations also license our products and services indirectly, primarily through large account resellers (LARs), distributors, value-added resellers (VARs), OEMs, system builder channels, and retailers. Although each type of reselling partner reaches organizations of all sizes, LARs are primarily engaged with large organizations, distributors resell primarily to VARs, and VARs typically reach small-sized and medium-sized organizations. Enterprise Software Advisors typically are also authorized as LARs and operate as resellers for our other licensing programs, such as the Select Plus and Open licensing programs discussed under Licensing Options below. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include CDW, Dell, Insight Enterprises, and Software House International. Our Microsoft Dynamics software offerings are licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our retail packaged products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets, including Microsoft Stores. Individual consumers obtain these products primarily through retail outlets, such as Wal-Mart and Dixons. We have a network of field sales representatives and field support personnel that solicits orders from distributors and resellers, and provides product training and sales support.

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Online

Although client-based software will continue to be an important part of our business, increasingly we are delivering additional value to customers through cloud-based services. We provide online content and services to consumers through Bing, MSN portals and channels, Microsoft Office Web Apps, Windows Phone Marketplace, Xbox LIVE, and Zune Marketplace. We provide content and services to business users through the Microsoft Online Services platform, which includes cloud-based services such as Exchange Online, Microsoft Dynamics CRM Online, Microsoft Lync, Microsoft Office 365, Microsoft Office Communications Online, Microsoft Office Live Meeting, SQL Azure, SharePoint Online, Windows Azure, and Windows Intune. Other services delivered online include our online advertising platform with offerings for advertisers, as well as Microsoft Developer Networks subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling our products and solutions. We also sell our products through our online store, microsoftstore.com.

LICENSING OPTIONS

We license software to organizations under arrangements that allow the end-user customer to acquire multiple licenses of products and services. Our arrangements for organizations to acquire multiple licenses of products and services are designed to provide them with a means of doing so without having to acquire separate packaged product through retail channels. In delivering organizational licensing arrangements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include those discussed below.

Open Licensing

Designed primarily for small-to-medium organizations, Open Programs allows customers to acquire perpetual or subscription licenses and, at the customer s election, rights to future versions of software products over a specified time period (two or three years depending on the Open Programs used). The offering that conveys rights to future versions of certain software products over the contract period is called software assurance. Software assurance also provides support, tools, and training to help customers deploy and use software efficiently. Open Programs has several variations to fit customers diverse way of purchasing. Under the Open License Program, customers can acquire licenses only, or licenses with software assurance. They can also renew software assurance upon the expiration of existing volume licensing agreements.

Select Plus Licensing

Designed primarily for medium-to-large organizations, the Select Plus Program allows customers to acquire perpetual licenses and, at the customer s election, software assurance over a specified time period (generally three years or less). Similar to Open Programs, the Select Plus Program allows customers to acquire licenses only, acquire licenses with software assurance, or renew software assurance upon the expiration of existing volume licensing agreements. Online services are also available for purchase through the Select Plus Program, and subscriptions are generally structured with terms between one and three years.

Services Provider Licensing

The Microsoft Services Provider License Agreement (SPLA) is a program targeted to service providers and Independent Software Vendors (ISVs) allowing these partners to provide software services and hosted applications to their end customers. Agreements are generally structured with a three-year term, and partners are billed monthly based upon consumption.

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Enterprise Agreement Licensing

Enterprise agreements are targeted at medium and large organizations that want to acquire licenses to Online Services and/or software products, along with software assurance, for all or substantial parts of their enterprise. Enterprises can elect to either acquire perpetual licenses or, under the Enterprise Subscription Program, can acquire non-perpetual, subscription agreements for a specified time period (generally three years). Online Services are also available for purchase through the Enterprise agreement and subscriptions are generally structured with three year terms.

CUSTOMERS

Our customers include individual consumers, small- and medium-sized organizations, enterprises, governmental institutions, educational institutions, Internet service providers, application developers, and OEMs. Consumers and small- and medium-sized organizations obtain our products primarily through distributors, resellers, and OEMs. No sales to an individual customer accounted for more than 10% of fiscal year 2012, 2011, or 2010 revenue. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of July 26, 2012 were as follows:

Name	Age	Position with the Company
Steven A. Ballmer	56	Chief Executive Officer
Lisa E. Brummel	52	Chief People Officer
Kurt D. DelBene	52	President, Microsoft Office Division
Peter S. Klein	49	Chief Financial Officer
Craig J. Mundie	63	Chief Research and Strategy Officer
Satya Nadella	44	President, Server and Tools Business
Steven Sinofsky	46	President, Windows & Windows Live Division
Bradford L. Smith	53	Executive Vice President; General Counsel; Secretary
B. Kevin Turner	47	Chief Operating Officer

Mr. Ballmer was appointed Chief Executive Officer in January 2000. He served as President from July 1998 to February 2001. Previously, he had served as Executive Vice President, Sales and Support since February 1992. Mr. Ballmer joined Microsoft in 1980.

Ms. Brummel was named Senior Vice President, Human Resources in December 2005 and in 2011 her title changed to Chief People Officer. She had been Corporate Vice President, Human Resources since May 2005. From May 2000 to May 2005, she had been Corporate Vice President of the Home & Retail Division. Since joining Microsoft in 1989, Ms. Brummel has held a number of management positions at Microsoft, including General Manager of Consumer Productivity Business, Product Unit Manager of the Kids Business, and Product Unit Manager of Desktop and Decision Reference Products.

Mr. DelBene was named President, Microsoft Office Division in September 2010. He served as Senior Vice President for the Microsoft Business Division since 2006. Since joining Microsoft in 1992, Mr. DelBene has served in several roles in Microsoft s product development teams, including Vice President of Authoring and Collaboration Services, General Manager of Microsoft Outlook, Group Program Manager for Microsoft Exchange, and Group Manager in Microsoft s Systems Division.

Mr. Klein was named Chief Financial Officer in November 2009. He served as Corporate Vice President, Chief Financial Officer, Microsoft Business Division from February 2006 to November 2009 and Chief Financial Officer of Server and Tools from July 2003 to February 2006. Mr. Klein joined Microsoft in 2002.

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Mr. Mundie was named Chief Research and Strategy Officer in June 2006. He had been Senior Vice President and Chief Technical Officer, Advanced Strategies and Policy since August 2001. He was named Senior Vice President, Consumer Platforms in February 1996. Mr. Mundie joined Microsoft in 1992.

Mr. Nadella was named President, Server and Tools in February 2011. He previously held other leadership positions at Microsoft including Senior Vice President Research and Development for the Online Services Division since 2008 and Corporate Vice President, Research and Development for the Advertising Platform since 2007. From 2000 to 2007, Mr. Nadella led Microsoft Business Solutions. Prior to that, he spent several years leading engineering efforts in Microsoft s Server group. Mr. Nadella joined Microsoft in 1992.

Mr. Sinofsky was named President, Windows & Windows Live Division in July 2009. He served as Senior Vice President of the Windows & Windows Live Engineering Group since December 2006 and Senior Vice President, Office from December 1999 to December 2006. He had been Vice President, Office since December 1998. Mr. Sinofsky joined the Office team in 1994, increasing his responsibility with each subsequent release of the desktop suite. Mr. Sinofsky joined Microsoft in 1989.

Mr. Smith was named Senior Vice President, General Counsel, and Secretary in November 2001 and in 2011 his title changed to Executive Vice President, General Counsel, and Secretary. Mr. Smith was also named Chief Compliance Officer effective July 2002. He had been Deputy General Counsel for Worldwide Sales and previously was responsible for managing the European Law and Corporate Affairs Group, based in Paris. Mr. Smith joined Microsoft in 1993.

Mr. Turner was named Chief Operating Officer in September 2005. Before joining Microsoft, he was Executive Vice President of Wal-Mart Stores, Inc. and President and Chief Executive Officer of the Sam s Club division. From September 2001 to August 2002, he served as Executive Vice President and Chief Information Officer of Wal-Mart s Information Systems Division. From March 2000 to September 2001, he served as its Senior Vice President and Chief Information Officer of the Information Systems Division.

EMPLOYEES

As of June 30, 2012, we employed approximately 94,000 people on a full-time basis, 55,000 in the U.S. and 39,000 internationally. Of the total, 36,000 were in product research and development, 25,000 in sales and marketing, 18,000 in product support and consulting services, 6,000 in manufacturing and distribution, and 9,000 in general and administration. Our success is highly dependent on our ability to attract and retain qualified employees. None of our employees are subject to collective bargaining agreements.

AVAILABLE INFORMATION

Our Internet address is www.microsoft.com. At our Investor Relations website, www.microsoft.com/investor, we make available free of charge a variety of information for investors. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, including:

- our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission (SEC);

- information on our business strategies, financial results, and key performance indicators;

announcements of investor conferences, speeches, and events at which our executives talk about our product, service, and competitive strategies. Archives of these events are also available;

press releases on quarterly earnings, product and service announcements, legal developments, and international news;

corporate governance information including our articles, bylaws, governance guidelines, committee charters, codes of conduct and ethics, global corporate citizenship initiatives, and other governance-related policies;

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- other news and announcements that we may post from time to time that investors might find useful or interesting; and
- opportunities to sign up for email alerts and RSS feeds to have information pushed in real time.

The information found on our website is not part of this or any other report we file with, or furnish to, the SEC.

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock.

We face intense competition across all markets for our products and services, which may lead to lower revenue or operating margins.

Competition in the technology sector. Our competitors range in size from diversified global companies with significant research and development resources to small, specialized firms whose narrower product lines may let them be more effective in deploying technical, marketing, and financial resources. Barriers to entry in our businesses generally are low and software products can be distributed broadly and quickly at relatively low cost. Many of the areas in which we compete evolve rapidly with changing and disruptive technologies, shifting user needs, and frequent introductions of new products and services. Our ability to remain competitive depends on our success in making innovative products that appeal to businesses and consumers.

Competition among platforms, ecosystems, and devices. An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A well-established ecosystem creates beneficial network effects among users, application developers and the platform provider that can accelerate growth. Establishing significant scale in the marketplace is necessary to achieve and maintain competitive margins. The strategic importance of a vibrant ecosystem increases as we launch the Windows 8 operating system, Surface devices, and associated cloud-based services. We face significant competition from firms that provide competing platforms, applications and services.

- A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has been successful with some consumer products such as personal computers, mobile phones, gaming consoles, and digital music players. These competitors also earn revenue from services that are integrated with the hardware and software platform. We also offer vertically-integrated hardware and software products and services; however, our competitors have been in the market longer and in some cases have established significantly large user bases. Efforts to compete with the vertically integrated model will increase our cost of revenue and reduce our operating margins.
- We derive substantial revenue from licenses of Windows operating systems on personal computers. The proliferation of alternative devices and form factors, in particular mobile devices such as smartphones and tablet computers, creates challenges from competing software platforms. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users may increasingly turn to these devices to perform functions that would have been performed by personal computers in the past. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract applications developers to our platforms. In addition, our Surface devices will compete with products made by our OEM partners, which may affect their commitment to our platform.

Competing platforms have applications marketplaces (sometimes referred to as stores) with scale and significant installed bases on mobile devices. These applications leverage free and user-paid services that over time result in disincentives for users to switch to competing platforms. In order to compete, we must successfully enlist developers to write applications for our marketplace and ensure that these applications have high quality, customer appeal and value. Efforts to compete with these application marketplaces may increase our cost of revenue and lower our operating margins.

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Business model competition. Companies compete with us based on a growing variety of business models.

- Under the license-based proprietary software model that generates most of our revenue, we bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from licensing our products. Many of our competitors also develop and sell software to businesses and consumers under this model and we expect this competition to continue.

- Other competitors develop and offer free online services and content, and make money by selling third-party advertising. Advertising revenues fund development of products and services these competitors provide to users at no or little cost, competing directly with our revenue-generating products.

- Some companies compete with us using an open source business model by modifying and then distributing open source software at nominal cost to end users and earning revenue on advertising or complementary services and products. These firms do not bear the full costs of research and development for the software. Some open source software vendors develop software that mimics the features and functionality of our products.

The competitive pressures described above may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives. This may lead to lower revenue, gross margins, and operating income.

Our increasing focus on devices and services presents execution and competitive risks. A growing part of our strategy involves cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and in some cases the user s choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provide us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

- continuing to bring to market compelling cloud-based experiences that generate increasing traffic and market share;

- maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including PCs, smartphones, tablets, and television-related devices;

- continuing to enhance the attractiveness of our cloud platforms to third-party developers; and

- ensuring that our cloud-based services meet the reliability expectations of our customers and maintain the security of their data.

We make significant investments in new products and services that may not be profitable. We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, the Windows Store, the Windows Azure Services platform, Office 365, other cloud-based services offerings, and the Xbox 360 entertainment platform. We will also continue to invest in new software and hardware products, services, and technologies, such as the Surface line of Microsoft-designed and manufactured devices announced in June 2012. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

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In fall 2012, we are launching Windows 8, a major new release of our PC operating system that seeks to deliver a unique user experience through well-integrated software, hardware, and services. Its success depends on a number of factors including the extent to which customers embrace its new user interface and functionality, successfully coordinating with our OEM partners in releasing a variety of hardware devices that take advantage of its features, and attracting developers at scale to ensure a competitive array of quality applications. We expect to incur substantial marketing costs in launching Window 8 and associated services and devices, which may reduce our operating margins.

We may not be able to adequately protect our intellectual property rights. Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets may grow slower than the underlying PC market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

Third parties may claim we infringe their intellectual property rights. From time to time, we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow because of constant technological change in the segments in which we compete, the extensive patent coverage of existing technologies, and the rapid rate of issuance of new patents. To resolve these claims we may enter into royalty and licensing agreements on terms that are less favorable than currently available, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. These outcomes may cause operating margins to decline. In addition to money damages, in some jurisdictions plaintiffs can seek injunctive relief that may limit or prevent importing, marketing, and selling our products that have infringing technologies. In some countries, such as Germany, an injunction can be issued before the parties have fully litigated the validity of the underlying patents. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights and to procure intellectual property rights as part of our strategy to manage this risk.

We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code. Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

Cyber-attacks and security vulnerabilities could lead to reduced revenue, increased costs, liability claims, or harm to our competitive position.

Security of Microsoft s information technology. Maintaining the security of computers and computer networks is paramount for us and our customers. Threats to information technology (IT) security can take a variety of forms. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products and services and gain access to our networks and data centers. Groups of hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks. Sophisticated organizations or individuals may launch targeted attacks using novel methods to gain access to computers running our software. These threats may result in breaches of our network or data security, disruptions of our internal systems and business applications, impairment of our ability to provide services to our customers, product development delays, harm to our competitive position from the compromise of confidential business information, or other negative impacts on our business.

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In addition, our internal IT environment continues to evolve. Often we are early adopters of new devices and technologies. We embrace new ways of sharing data and communicating internally and with partners and customers using methods such as social networking and other consumer-oriented technologies. These practices can enhance efficiency and business insight, but they also present risks that our business policies and internal security controls may not keep pace with the speed of these changes.

Security of our customers products and services. Security threats are a particular challenge to companies like us whose business is technology products and services. The threats to our own IT infrastructure also affect our customers. Customers using our cloud services rely on the security of our infrastructure to ensure the reliability of our services and the protection of their data. Hackers tend to focus their efforts on the most popular operating systems, programs, and services, including many of ours, and we expect them to continue to do so. The security of our products and services is an important consideration in our customers purchasing decisions.

We devote significant resources to defend against security threats, both to our internal IT systems and those of our customers. These include:

- engineering more secure products and services;
- enhancing security and reliability features in our products and services, and continuously evaluating and updating those security and reliability features;
- improving the deployment of software updates to address security vulnerabilities;
- investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed;
- protecting the digital security infrastructure that ensures the integrity of our products and services;
- helping our customers make the best use of our products and services to protect against computer viruses and other attacks; and
- providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products and services could cause significant reputational harm and lead some customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges. Legislative or regulatory action may increase the costs to develop or implement our products and services.

Improper disclosure of personal data could result in liability and harm our reputation. As we continue to execute our strategy of increasing the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. At the same time, the continued occurrence of high-profile data breaches provides evidence of an external environment increasingly hostile to information security. This environment demands that we continuously improve our design and coordination of security controls across our business groups and geographies. Despite these efforts, it is possible our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information that we or our vendors store and manage. Improper disclosure of this information could harm our reputation, lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data on premise or, increasingly, in a cloud-based environment we host. We believe consumers using our email, messaging, storage, sharing, and social networking services will increasingly want efficient, centralized methods of choosing their privacy preferences and controlling their data. Perceptions that our products or services do not adequately protect the privacy of personal information could inhibit sales of our products or services, and could constrain consumer and business adoption of our cloud-based solutions.

We may experience outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our websites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, Office 365, SharePoint Online, Skype, Xbox LIVE, Windows Azure, Windows Live, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-party businesses to their end customers. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

We are subject to government litigation and regulatory activity that affects how we design and market our products. As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints included limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. Although the Consent Decree and Final Judgment expired in May 2011, we expect that federal and state antitrust authorities will continue to closely scrutinize our business.

The European Commission closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments offered by Microsoft to address the Commission s concerns relating to competition in Web browsing software. The Commission s impact on product design may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our own products which could result in decreased sales of our products.

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenue that come from them. New actions could be initiated at any time, either by these or other governments or private claimants, including with respect to new versions of Windows or other Microsoft products. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

- We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and removing functionality that customers want or on which developers rely.

We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.

The rulings described above may be used as precedent in other competition law proceedings.

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We are subject to a variety of ongoing commitments as a result of court or administrative orders, consent decrees or other voluntary actions we have taken. If we fail to comply with these commitments we may incur litigation costs and be subject to fines or other remedial actions. For example, in July 2012 we announced that, for some PCs sold in Europe, we were not in compliance with our 2009 agreement to display a Browser Choice Screen on Windows PCs where Internet Explorer is the default browser.

Our products and online services offerings, including new technologies we develop or acquire such as Skype, are subject to government regulation in some jurisdictions, including in areas of user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear, subject to change over time, and sometimes may conflict from jurisdiction to jurisdiction. Additionally these laws and governments approach to their enforcement, as well as our products and services, are continuing to evolve. Compliance with these types of regulation may involve significant costs or require changes in products or business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

Our business depends on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

Delays in product development schedules may adversely affect our revenue. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on cloud-based software plus services also presents new and complex development issues. Significant delays in new product or service releases or significant problems in creating new products or services could adversely affect our revenue.

We make significant investments in new products and services that may not be profitable. Our growth depends on our ability to create new and higher value product and service offerings. We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, the Windows Store, the Windows Azure Services platform, Office 365, other cloud-based services offerings, and the Xbox 360 entertainment platform. In June 2012, we announced the Surface line of Microsoft-designed and manufactured devices. We will also continue to invest in new software and hardware products, services, and technologies. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow our share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over a variety of form factors including PC, phone, and TV device classes. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Adverse economic conditions may harm our business. Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower information technology spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. Our product distribution system also relies on an extensive partner and retail network. Original equipment manufacturers (OEMs) building devices that run our software have also been a significant means of distribution. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, OEM, or retailer, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and

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services they have purchased. As a result, allowances for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that have affected global financial markets. A significant part of our investment portfolio consists of U.S. government securities. If global credit and equity markets experience prolonged periods of decline, or if there is a downgrade of U.S. government debt, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely affect our financial results.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. Although management currently believes resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial statements, the litigation and other claims are subject to inherent uncertainties and management s view of these matters may change in the future. A material adverse impact on our financial statements also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions to the U.S. may result in higher effective tax rates for the company. In addition, there have been proposals to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form any proposed legislation may pass, if enacted it could have a material adverse impact on our tax expense and cash flow.

Our hardware and software products may experience quality or supply problems. Our vertically-integrated hardware products such as the Xbox 360 console, Surface devices, and other hardware devices we design and market are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. Our competitors use some of the same suppliers and their demand for hardware components can affect the amount of capacity available to us. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either component shortages or excess or obsolete inventory may increase our cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

Our stand-alone software products may also experience quality or reliability problems. The highly sophisticated software products we develop may contain bugs and other defects that interfere with their intended operation. Any defects we do not detect and fix in pre-release testing could result in reduced sales and revenue, damage to our reputation, repair or remediation costs, delays in the release of new products or versions, or legal liability. Although our license agreements typically contain provisions that eliminate or limit our exposure to liability, there is no assurance these provisions will withstand legal challenge.

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. We acquire other companies and may not realize all the economic benefit from those acquisitions, which could result in an impairment of goodwill or intangibles. Under accounting principles generally accepted in the United States (U.S. GAAP), we review our amortizable intangible assets for impairment when

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events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations. For example, in July 2012, we announced a $6.2 billion charge for the impairment of goodwill in our Online Services Division business segment.

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries. Operations outside the U.S. may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments by our employees, vendors, or agents. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region, such as current uncertainties relating to European sovereign and other debt, and difficulties in staffing and managing foreign operations, may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenue.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations because of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations. Our move toward providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may result in supply chain disruptions for hardware manufacturers, either of which may adversely affect our revenue. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures and strategic alliances as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not realize a satisfactory return on our investment, or that we experience difficulty integrating new employees, business systems, and technology, or diversion of management s attention from our other businesses. Our recent acquisition of Skype, for example, provides opportunities to enhance our existing products. The success of our integration of Skype will depend in part on our ability to provide compelling experiences that distinguish us from our competitors in both consumer and business markets. It may take longer than expected to realize the full benefits from these transactions, such as increased revenue, enhanced efficiencies, or market share, or those benefits may ultimately be smaller than anticipated or may not be realized. These events could harm our operating results or financial condition.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

We have received no written comments regarding our periodic or current reports from the staff of the SEC that were issued 180 days or more preceding the end of our fiscal year 2012 that remain unresolved.

ITEM 2. PROPERTIES

Our corporate offices consist of approximately 15 million square feet of office space located in King County, Washington: 10 million square feet of owned space situated on approximately 500 acres of land we own at our corporate campus in Redmond, Washington and approximately five million square feet of space we lease. We own approximately three million additional square feet of office and data center space domestically (outside of the Puget Sound corporate campus) and lease many sites domestically totaling approximately four million square feet of office and data center space.

We occupy many sites internationally, totaling approximately three million square feet that is owned and approximately nine million square feet that is leased. International facilities that we own include our development center in Hyderabad, India; our European operations center in Dublin, Ireland; a research and development campus in Beijing, China; and facilities in Reading, UK. The largest leased office spaces include the following locations: Beijing and Shanghai, China; Tokyo, Japan; Unterschleissheim, Germany; Paris, France; Dublin, Ireland; Bangalore, India; Reading, UK; Vedbaek, Denmark; and Mississauga, Canada. In addition to the above locations, we have a disk duplication and digital distribution facility in Humacao, Puerto Rico, a facility in Singapore for our Asia Pacific operations center and regional headquarters, and various product development facilities, both domestically and internationally, as described in the Research and Development section of Item 1 of this Form 10-K.

Our facilities are fully used for current operations of all segments, and suitable additional spaces are available to accommodate expansion needs. We have a development agreement with the City of Redmond under which we may currently develop approximately 1.6 million square feet of additional facilities at our corporate campus in Redmond, Washington. In addition, we own 63 acres of undeveloped land in Issaquah, Washington, that can accommodate approximately one million square feet of office space.

ITEM 3. LEGAL PROCEEDINGS

See Note 17 Contingencies of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for information regarding legal proceedings in which we are involved.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

MARKET AND STOCKHOLDERS

Our common stock is traded on the NASDAQ Stock Market under the symbol MSFT. On July 18, 2012, there were 128,992 registered holders of record of our common stock. The high and low common stock sales prices per share were as follows:

Quarter Ended	**September 30**	**December 31**	**March 31**	**June 30**	**Fiscal Year**
Fiscal Year 2012					
High	**$ 28.15**	**$ 27.50**	**$ 32.95**	**$ 32.89**	**$ 32.95**
Low	**$ 23.79**	**$ 24.26**	**$ 26.39**	**$ 28.32**	**$ 23.79**
Fiscal Year 2011					
High	$ 26.41	$ 28.87	$ 29.46	$ 26.87	$ 29.46
Low	$ 22.73	$ 23.78	$ 24.68	$ 23.65	$ 22.73

DIVIDENDS AND SHARE REPURCHASES

See Note 18 Stockholders Equity of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for information regarding dividends and share repurchases by quarter. Following are our monthly stock repurchases for the fourth quarter of fiscal year 2012, all of which were purchased as part of publicly announced plans or programs:

Period	**Total Number of Shares Purchased**	**Average Price Paid per Share**	**Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**	**Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs**
				(in millions)
April 1, 2012 April 30, 2012	404,577	$ 31.98	404,577	$ 9,208
May 1, 2012 May 31, 2012	27,154,632	$ 30.50	27,154,632	$ 8,379
June 1, 2012 June 30, 2012	5,485,035	$ 28.97	5,485,035	$ 8,221

	33,044,244	33,044,244

The repurchases were made using cash resources and occurred in the open market.

ITEM 6. SELECTED FINANCIAL DATA

FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Year Ended June 30,	**2012**	**2011**	**2010**	**2009**	**2008**
Revenue	**$ 73,723**	$ 69,943	$ 62,484	$ 58,437	$ 60,420
Operating income	**$ 21,763** [(a)]	$ 27,161	$ 24,098	$ 20,363	$ 22,271 [(b)]
Net income	**$ 16,978** [(a)]	$ 23,150	$ 18,760	$ 14,569	$ 17,681 [(b)]
Diluted earnings per share	**$ 2.00** [(a)]	$ 2.69	$ 2.10	$ 1.62	$ 1.87
Cash dividends declared per share	**$ 0.80**	$ 0.64	$ 0.52	$ 0.52	$ 0.44
Cash, cash equivalents, and short-term investments	**$ 63,040**	$ 52,772	$ 36,788	$ 31,447	$ 23,662
Total assets	**$ 121,271**	$ 108,704	$ 86,113	$ 77,888	$ 72,793
Long-term obligations	**$ 22,220**	$ 22,847	$ 13,791	$ 11,296	$ 6,621
Stockholders equity	**$ 66,363**	$ 57,083	$ 46,175	$ 39,558	$ 36,286

(a) *Includes a goodwill impairment charge related to our Online Services Division business segment which decreased operating income and net income by $6.2 billion and diluted earnings per share by $0.73.*

(b) *Includes a charge of $1.4 billion (899 million) related to the fine imposed by the European Commission in February 2008.*

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management s Discussion and Analysis (MD&A) is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying Notes to Financial Statements.

OVERVIEW AND OUTLOOK

Microsoft is a technology leader focused on helping people and businesses throughout the world realize their full potential. We create technology that transforms the way people work, play, and communicate across a wide range of computing devices.

We generate revenue by developing, licensing, and supporting a wide range of software products and services, including cloud-based services, by designing and selling hardware, and by delivering relevant online advertising to a global audience. Our most significant expenses are related to compensating employees, designing, manufacturing, marketing, and selling our products and services, and income taxes.

Industry Trends

Our industry is dynamic and highly competitive, with frequent changes in both technologies and business models. Each industry shift is an opportunity to conceive new products, new technologies, or new ideas that can further transform the industry and our business. At Microsoft, we push the boundaries of what is possible through a broad range of research and development activities that seek to anticipate the changing demands of customers, industry trends, and competitive forces.

Key Opportunities and Investments

Based on our assessment of key technology trends and our broad focus on long-term research and development of new products and services, we see significant opportunities to drive future growth.

Smart connected devices

The price per unit of processing, storage, and networks continues to decline while at the same time devices increase in capability. As a result, the capabilities and accessibility of PCs, tablets, phones, televisions, and other devices powered by rich software platforms and applications continue to grow. At the same time, the information and services people use increasingly span multiple devices enabled by the adoption of cloud computing.

For example, the delivery and quality of unified entertainment experiences across devices is undergoing dramatic evolution. These rich media experiences include books, magazines, newspapers, games, movies, music, television, and social interactions with family, friends, and colleagues. At Microsoft, our approach is to simplify and increase the accessibility of these entertainment experiences to broaden market penetration of our software, hardware, and services.

Additionally, web content and social connections have increased tremendously as people spend more time online, while discoverability and accessibility has been transforming from direct navigation and document links. There is significant opportunity to deliver products and services that help users make faster, better decisions and complete tasks more simply when using their devices. Our approach is to use machine learning to understand user intent, and differentiate our products and services by focusing on the integration of speech, visual, social, and other elements to simplify people s interaction with the Internet.

We invest significant resources in enabling and developing smart connected devices that offer a unified, seamless experience across a common platform. Whether a PC, Windows Phone, Xbox 360, or the newly announced Surface

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devices, our goal is to provide users with a consistent and compelling experience through a common user interface and our services such as SkyDrive, Xbox LIVE, Bing, Skype, and our Windows Azure cloud platform.

Communications and productivity

The ubiquity of computing and software tools has transformed personal and business productivity. Over the last decade, Microsoft redefined software productivity beyond the rich Office client on the PC. Productivity scenarios now encompass unified communications such as instant messaging, voice, and video communications, business intelligence, collaboration, content management, and relationship management, all of which are increasingly available through server-side applications. These server applications can be hosted in the cloud by the customer, a partner, or by Microsoft. There are significant opportunities to bring to life productivity and communication scenarios across PCs, mobile, and other devices that connect to services. We invest significant resources in our products and services that make this possible Dynamics, Exchange, Lync, Skype, Office, Office 365, SharePoint, Windows Live, and Windows Phone.

Cloud computing transforming the data center and information technology

Cloud-based solutions provide customers with software, services, and content over the Internet by way of shared computing resources located in centralized data centers. Computing is undergoing a long-term shift from client/server to the cloud, a shift similar in importance and impact to the transition from mainframe to client/server. The shift to the cloud is driven by three important economies of scale: larger data centers can deploy computational resources at significantly lower cost per unit than smaller ones; larger data centers can coordinate and aggregate diverse customer, geographic, and application demand patterns improving the utilization of computing, storage, and network resources; and multi-tenancy lowers application maintenance labor costs for large public clouds. Because of the improved economics, the cloud offers unique levels of elasticity and agility that enables new solutions and applications. For businesses of all sizes, the cloud creates the opportunity to focus on innovation while leaving non-differentiating activities to reliable and cost-effective providers. We are devoting significant resources to developing cloud infrastructure, platforms, and applications including offerings such as Microsoft Dynamics Online, Microsoft SQL Azure, Office 365, Windows Azure, Windows Intune, and Windows Server.

Economic Conditions, Challenges, and Risks

As discussed above, our industry is dynamic and highly competitive. We must anticipate changes in technology and business models. Our model for growth is based on our ability to initiate and embrace disruptive technology trends, to enter new markets, both in terms of geographies and product areas, and to drive broad adoption of the products and services we develop and market.

At Microsoft, we prioritize our investments among the highest long-term growth opportunities. These investments require significant resources and are multi-year in nature. The products and services we bring to market may be developed internally, brought to market as part of a partnership or alliance, or through acquisition.

Our success is highly dependent on our ability to attract and retain qualified employees. We hire a mix of university and industry talent worldwide. Microsoft competes for talented individuals worldwide by offering broad customer reach, scale in resources, and competitive compensation.

Demand for our software, services, and hardware has a strong correlation to global macroeconomic factors. The current macroeconomic factors remain dynamic. See a discussion of these factors and other risks under Risk Factors (Part II, Item 1A. of this Form 10-K).

Seasonality

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending

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by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its yearly segment revenue in our second fiscal quarter.

Unearned Revenue

Quarterly and annual revenue may be impacted by the deferral of revenue. See the discussions below regarding sales of earlier versions of the Microsoft Office system with a guarantee to be upgraded to the newest version of the Microsoft Office system at minimal or no cost (the Office Deferral), sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost (the Windows 7 Deferral), and sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the Windows Upgrade Offer).

RESULTS OF OPERATIONS

Summary

(In millions, except percentages and per share amounts)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Revenue	**$ 73,723**	$ 69,943	$ 62,484	5%	12%
Operating income	**$ 21,763**	$ 27,161	$ 24,098	(20)%	13%
Diluted earnings per share	**$ 2.00**	$ 2.69	$ 2.10	(26)%	28%

Fiscal year 2012 compared with fiscal year 2011

Revenue increased primarily due to strong sales of Server and Tools products and services and the 2010 Microsoft Office system, offset in part by the decline in Windows operating system revenue primarily due to the deferral of $540 million of revenue relating to the Windows Upgrade Offer. Revenue in fiscal year 2012 also included Skype revenue from the date of acquisition.

Operating income decreased reflecting a goodwill impairment charge of $6.2 billion related to our OSD business segment. Other key changes in operating expenses were:

Cost of revenue increased $2.0 billion or 13%, reflecting higher costs associated with providing Server and Tools products and services, payments made to Nokia related to joint strategic initiatives, higher Xbox 360 royalty costs, and other changes in the mix of products and services sold.

Research and development expenses increased $768 million or 8%, due mainly to higher headcount-related expenses.

General and administrative expenses increased $347 million or 8%, due mainly to higher headcount-related expenses and the full year impact of new Puerto Rican excise taxes, offset in part by decreased legal charges.

Headcount-related expenses were higher across the company reflecting a 4% increase in headcount from June 30, 2011 and changes in our employee compensation program.

Diluted earnings per share were negatively impacted by the non-tax deductible goodwill impairment charge, which decreased diluted earnings per share by $0.73. Prior year net income and diluted earnings per share reflected a partial settlement with the U.S. Internal Revenue Service (I.R.S.) and higher other income. The partial settlement with the I.R.S. added $461 million to net income and $0.05 to diluted earnings per share in the prior year.

Fiscal year 2011 compared with fiscal year 2010

Revenue increased primarily due to strong sales of the Xbox 360 entertainment platform, the 2010 Microsoft Office system, and Server and Tools products, offset in part by lower Windows revenue. Revenue also increased due to

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the $254 million Office Deferral in fiscal year 2010 and the subsequent recognition of the Office Deferral during fiscal year 2011. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income increased reflecting the change in revenue, offset in part by higher operating expenses. Key changes in operating expenses were:

- Cost of revenue increased $3.2 billion or 26%, due to higher costs associated with our online offerings, including traffic acquisition costs, and increased volumes of Xbox 360 consoles and Kinect for Xbox 360 sold.

- Sales and marketing expenses increased $726 million or 5%, primarily reflecting increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, higher headcount-related expenses and increased fees paid to third-party enterprise software advisors.

- Research and development expenses increased $329 million or 4%, due mainly to higher headcount-related expenses.

- General and administrative expenses increased $159 million or 4%, due mainly to higher headcount-related expenses and new Puerto Rican excise taxes, partially offset by prior year transition expenses associated with the inception of the Yahoo! Commercial Agreement.

Diluted earnings per share increased, reflecting higher revenue, repurchases of common stock, and lower income tax expense, offset in part by higher operating expenses.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. (U.S. GAAP) and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 21 Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Forefront Protection for Office, an anti-malware solution, from Server and Tools to the Microsoft Business Division.

Windows & Windows Live Division

(In millions, except percentages)	**2012**	**2011**	**2010**	**Percentage Change 2012 Versus 2011**	**Percentage Change 2011 Versus 2010**
Revenue	**$ 18,373**	$ 19,033	$ 19,491	(3)%	(2)%
Operating income	**$ 11,460**	$ 12,211	$ 12,895	(6)%	(5)%

Windows & Windows Live Division (Windows Division) develops and markets PC operating systems, related software and online services, and PC hardware products. This collection of software, hardware, and services is designed to simplify everyday tasks through seamless operations across the user s hardware and software and efficient browsing capabilities. Windows Division offerings consist of the Windows operating system, software and services through Windows Live, and Microsoft PC hardware products.

Windows Division revenue is largely correlated to the PC market worldwide, as approximately 75% of total Windows Division revenue comes from Windows operating system software purchased by original equipment manufacturers (OEMs) which they pre-install on equipment they sell. The remaining approximately 25% of Windows Division revenue is generated by commercial and retail sales of Windows and PC hardware products and online advertising from Windows Live.

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Fiscal year 2012 compared with fiscal year 2011

Windows Division revenue reflected relative performance in PC market segments. We estimate that sales of PCs to businesses grew approximately 4% and sales of PCs to consumers decreased 1%. Excluding a decline in sales of netbooks, we estimate that sales of PCs to consumers grew approximately 5%. Taken together, the total PC market increased an estimated 0% to 2%. Relative to PC market growth, Windows Division revenue was negatively impacted by higher growth in emerging markets, where average selling prices are lower than developed markets, and the deferral of $540 million of revenue relating to the Windows Upgrade Offer.

Windows Division operating income decreased, due mainly to lower revenue and a $163 million or 10% increase in research and development expenses, primarily associated with the Windows 8 operating system.

Fiscal year 2011 compared with fiscal year 2010

Windows Division revenue reflected relative performance in PC market segments. We estimate that sales of PCs to businesses grew approximately 11% this year and sales of PCs to consumers declined approximately 1%. The decline in consumer PC sales included an approximately 32% decline in the sales of netbooks. Taken together, the total PC market increased an estimated 2% to 4%. Revenue was negatively impacted by the effect of higher growth in emerging markets, where average selling prices are lower, relative to developed markets, and by lower recognition of previously deferred Windows XP revenue. Considering the impact of the Windows 7 launch in the prior year, including $273 million of revenue recognized related to the Windows 7 Deferral, we estimate that Windows Division revenue was in line with the PC market.

Windows Division operating income decreased as a result of decreased revenue and higher sales and marketing expenses. Sales and marketing expenses increased $182 million or 6%, reflecting increased advertising of Windows and Windows Live.

Server and Tools

(In millions, except percentages)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Revenue	**$ 18,686**	$ 16,680	$ 15,109	12%	10%
Operating income	**$ 7,431**	$ 6,290	$ 5,381	18%	17%

Server and Tools develops and markets technology and related services that enable information technology professionals and their systems to be more productive and efficient. Server and Tools product and service offerings include Windows Server, Microsoft SQL Server, Windows Azure, Visual Studio, System Center products, Windows Embedded device platforms, and Enterprise Services. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. We also offer developer tools, training, and certification. Approximately 55% of Server and Tools revenue comes primarily from multi-year volume licensing agreements, approximately 25% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Fiscal year 2012 compared with fiscal year 2011

Server and Tools revenue increased in both product sales and Enterprise Services. Product revenue increased $1.4 billion or 11%, driven primarily by growth in SQL Server, Windows Server, and System Center, reflecting continued adoption of the Windows platform. Enterprise Services revenue grew $595 million or 18%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by higher costs of providing products and services and increased sales and marketing expenses. Cost of revenue increased $682 million or 22%, primarily reflecting higher Enterprise Services headcount-related costs. Sales and marketing expenses grew $155 million or 4%, reflecting increased corporate marketing activities.

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Fiscal year 2011 compared with fiscal year 2010

Server and Tools revenue increased in both product sales and Enterprise Services. Product revenue increased $1.2 billion or 10%, driven primarily by growth in Windows Server, SQL Server, and System Center, reflecting continued adoption of the Windows platform. Enterprise Services revenue grew $353 million or 12%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased due to revenue growth, offset in part by higher operating expenses. Cost of revenue increased $377 million or 13%, primarily reflecting a $323 million increase in expenses from providing Enterprise Services. Sales and marketing expenses increased $270 million or 7%, reflecting increased fees paid to third-party enterprise software advisors and increased corporate marketing activities.

Online Services Division

(In millions, except percentages)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Revenue	**$ 2,867**	$ 2,607	$ 2,294	10%	14%
Operating loss	**$ (8,121)**	$ (2,657)	$ (2,408)	*	(10)%

* *Not meaningful*

Online Services Division (OSD) develops and markets information and content designed to help people simplify tasks and make more informed decisions online, and that help advertisers connect with audiences. OSD offerings include Bing, MSN, adCenter, and advertiser tools. Bing and MSN generate revenue through the sale of search and display advertising, accounting for nearly all of OSD s annual revenue.

Fiscal year 2012 compared with fiscal year 2011

Online advertising revenue grew $306 million or 13% to $2.6 billion, reflecting continued growth in search advertising revenue, offset in part by decreased display advertising revenue. Search revenue grew due to increased revenue per search, increased volumes reflecting general market growth, and share gains in the U.S. According to third-party sources, Bing organic U.S. market share for the month of June 2012 was approximately 16%, and grew 120 basis points year over year. Bing-powered U.S. market share, including Yahoo! properties, was approximately 26% for the month of June 2012, down 100 basis points year over year.

OSD s fiscal year 2012 operating loss reflects a goodwill impairment charge of $6.2 billion, which we recorded as a result of our annual goodwill impairment test in the fourth quarter. The non-cash, non-tax-deductible charge related mainly to goodwill acquired through our 2007 acquisition of aQuantive, Inc. While the search business has been improving, our expectations for future growth and profitability for OSD are lower than our previous estimates. We do not expect this impairment charge to affect OSD s ongoing business or financial performance.

Excluding the $6.2 billion goodwill impairment charge, OSD s operating loss was reduced by higher revenue and lower sales and marketing expenses and cost of revenue. Sales and marketing expenses decreased $321 million or 29%, due mainly to lower marketing spend. Cost of revenue decreased $213 million, driven by lower Yahoo! reimbursement costs, amortization, and online operating costs.

Fiscal year 2011 compared with fiscal year 2010

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew $351 million or 18% to $2.3 billion, reflecting continued growth in search and display advertising revenue, offset in part by decreased third-party advertising revenue. Search revenue grew due to increased volumes reflecting general market growth, share gains in the U.S., and our Yahoo! alliance, offset in part by decreased revenue per search primarily related to challenges associated with optimizing the adCenter platform for the new mix and volume of traffic from the combined Yahoo! and Bing properties. According to third-party sources, Bing organic U.S. market share for the month of June 2011 was approximately 14%, and grew 170 basis points year over year. Bing-powered U.S. market share, including Yahoo! properties, was approximately 27% for the month of June 2011.

OSD operating loss increased due to higher operating expenses, offset in part by increased revenue. Cost of revenue grew $647 million driven by costs associated with the Yahoo! search agreement and increased traffic acquisition costs. General and administrative expenses decreased $156 million or 58%, due mainly to transition expenses in the prior year associated with the inception of the Yahoo! Commercial Agreement. Research and development increased $123 million or 11% due to increased headcount-related costs.

Microsoft Business Division

(In millions, except percentages)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Revenue	**$ 23,991**	$ 22,514	$ 19,256	7%	17%
Operating income	**$ 15,719**	$ 14,657	$ 11,849	7%	24%

Microsoft Business Division (MBD) develops and markets software and online services designed to increase personal, team, and organization productivity. MBD offerings include the Microsoft Office system (comprising mainly Office, SharePoint, Exchange, Lync, and Office 365), which generates over 90% of MBD revenue, and Microsoft Dynamics business solutions. We evaluate MBD results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

Fiscal year 2012 compared with fiscal year 2011

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system. Business revenue increased $1.7 billion or 9%, primarily reflecting growth in multi-year volume licensing revenue, licensing of the 2010 Microsoft Office system to transactional business customers, and an 11% increase in Microsoft Dynamics revenue. Consumer revenue decreased $195 million or 4% due to the recognition of $254 million of revenue in the prior year associated with the Office Deferral. Excluding the fiscal year 2011 impact associated with the Office Deferral, consumer revenue increased $59 million, driven by increased sales of the 2010 Microsoft Office system.

MBD revenue for the year ended June 30, 2012 included a favorable foreign currency impact of $506 million.

MBD operating income increased, primarily due to revenue growth, offset in part by higher operating expenses. Cost of revenue increased $258 million or 16%, primarily due to higher online operation and support costs. Research and development expenses increased, due mainly to an increase in headcount-related costs.

Fiscal year 2011 compared with fiscal year 2010

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system, the $254 million Office Deferral during fiscal year 2010, and the subsequent recognition of the Office Deferral during fiscal year 2011. Business revenue increased $2.1 billion or 14%, reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year volume licensing revenue, and a 10% increase in Microsoft Dynamics revenue. Consumer revenue increased $1.1 billion or 33%, approximately half of which was attributable to the launch of Office 2010 and half of which was attributable to the Office Deferral during fiscal year 2010 and subsequent recognition of the Office Deferral during fiscal year 2011. Excluding the impact associated with the Office Deferral, consumer revenue increased $617 million or 17% due to sales of the 2010 Microsoft Office system.

MBD operating income increased due mainly to revenue growth, offset in part by higher operating expenses. Cost of revenue increased $328 million or 25%, primarily driven by higher online operation and support costs. Sales and marketing expenses increased, primarily driven by an increase in corporate and cross-platform marketing activities. Research and development costs increased, primarily as a result of capitalization of certain Microsoft Office system software development costs in the prior year.

Entertainment and Devices Division

(In millions, except percentages)	**2012**	**2011**	**2010**	**Percentage Change 2012 Versus 2011**	**Percentage Change 2011 Versus 2010**
Revenue	**$ 9,593**	$ 8,915	$ 6,079	8%	47%
Operating income	**$ 364**	$ 1,257	$ 517	(71)%	143%

Entertainment and Devices Division (EDD) develops and markets products and services designed to entertain and connect people. EDD offerings include the Xbox 360 entertainment platform (which includes the Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), Mediaroom (our Internet protocol television software), Skype, and Windows Phone, including related patent licensing revenue. In November 2010, we released Kinect for Xbox 360. We acquired Skype on October 13, 2011, and its results of operations from that date are reflected in our results discussed below.

Fiscal year 2012 compared with fiscal year 2011

EDD revenue increased primarily reflecting Skype and Windows Phone revenue, offset in part by lower Xbox 360 platform revenue. Xbox 360 platform revenue decreased $113 million, due mainly to decreased volumes of Kinect for Xbox 360 sold and lower video game revenue, offset in part by higher Xbox LIVE revenue. We shipped 13.0 million Xbox 360 consoles during fiscal year 2012, compared with 13.7 million Xbox 360 consoles during fiscal year 2011. Video game revenue decreased due to strong sales of Halo Reach in the prior year.

EDD operating income decreased reflecting higher operating expenses, offset in part by revenue growth. Cost of revenue grew $900 million or 16%, primarily due to changes in the mix of products and services sold and payments made to Nokia related to joint strategic initiatives. Research and development expenses increased $356 million or 30%, primarily reflecting higher headcount-related expenses. Sales and marketing expenses increased $244 million or 28%, primarily reflecting the inclusion of Skype expenses.

Fiscal year 2011 compared with fiscal year 2010

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew $2.7 billion or 48%, led by increased volumes of Xbox 360 consoles, sales of Kinect for Xbox 360, and higher Xbox LIVE revenue. We shipped 13.7 million Xbox 360 consoles during fiscal year 2011, compared with 10.3 million Xbox 360 consoles during fiscal year 2010.

EDD operating income increased primarily reflecting revenue growth, offset in part by higher cost of revenue. Cost of revenue increased $1.8 billion or 49%, primarily reflecting higher volumes of Xbox 360 consoles and Kinect for Xbox 360 sold, and increased royalty costs resulting from increased sales of Xbox LIVE digital content. Research and development expenses increased $160 million or 15%, primarily reflecting higher headcount-related costs. Sales and marketing expenses grew $112 million or 15%, primarily reflecting increased Xbox 360 platform marketing activities.

Corporate-Level Activity

(In millions, except percentages)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Corporate-level activity	**$ (5,090)**	$ (4,597)	$ (4,136)	(11)%	(11)%

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Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies.

Fiscal year 2012 compared with fiscal year 2011

Corporate-level expenses increased due mainly to full year Puerto Rican excise taxes, higher headcount-related expenses, and changes in foreign currency exchange rates. These increases were offset in part by lower legal charges, which were $56 million in fiscal year 2012 compared with $332 million in fiscal year 2011.

Fiscal year 2011 compared with fiscal year 2010

Corporate-level expenses increased due mainly to new Puerto Rican excise taxes, certain revenue related sales and marketing expenses, and increased headcount-related expenses. These increases were offset in part by lower legal charges, which were $332 million in fiscal year 2011 compared with $533 million in fiscal year 2010.

OPERATING EXPENSES

Cost of Revenue

(In millions, except percentages)	**2012**	**2011**	**2010**	**Percentage Change 2012 Versus 2011**	**Percentage Change 2011 Versus 2010**
Cost of revenue	**$ 17,530**	$ 15,577	$ 12,395	13%	26%
As a percent of revenue	**24%**	22%	20%	2ppt	2ppt

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our websites, and to acquire online advertising space (traffic acquisition costs); costs incurred to support and maintain Internet-based products and services including royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs.

Fiscal year 2012 compared with fiscal year 2011

Cost of revenue increased reflecting higher headcount-related costs, payments made to Nokia, and changes in the mix of products and services sold. Headcount-related expenses increased 20%, primarily related to increased Enterprise Services headcount.

Fiscal year 2011 compared with fiscal year 2010

Cost of revenue increased primarily due to increased volumes of Xbox 360 consoles and Kinect for Xbox 360 sold, higher costs associated with our online offerings, including traffic acquisition costs, and higher expenses from providing Enterprise Services, as well as royalty costs relating to Xbox LIVE digital content sold.

Research and Development

(In millions, except percentages)	2012	2011	2010	Percentage Change 2012 Versus 2011	Percentage Change 2011 Versus 2010
Research and development	**$ 9,811**	$ 9,043	$ 8,714	8%	4%
As a percent of revenue	**13%**	13%	14%	0ppt	(1)ppt

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Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content.

Fiscal year 2012 compared with fiscal year 2011

Research and development expenses increased, primarily reflecting a 10% increase in headcount-related expenses.

Fiscal year 2011 compared with fiscal year 2010

Research and development expenses increased primarily due to a 5% increase in headcount-related expenses and the capitalization of certain software development costs in the prior year.

Sales and Marketing

(In millions, except percentages)	**2012**	**2011**	**2010**	**Percentage Change 2012 Versus 2011**	**Percentage Change 2011 Versus 2010**
Sales and marketing	**$ 13,857**	$ 13,940	$ 13,214	(1)%	5%
As a percent of revenue	**19%**	20%	21%	(1)ppt	(1)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs.

Fiscal year 2012 compared with fiscal year 2011

Sales and marketing expenses decreased slightly, primarily reflecting decreased advertising and marketing of the Xbox 360 platform, Windows Phone, and Bing, offset in part by a 5% increase in headcount-related expenses.

Fiscal year 2011 compared with fiscal year 2010

Sales and marketing expenses increased, primarily as a result of increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, a 5% increase in headcount-related expenses, and increased fees paid to third-party enterprise software advisors.

General and Administrative

(In millions, except percentages)	**2012**	**2011**	**2010**	**Percentage Change 2012 Versus 2011**	**Percentage Change 2011 Versus 2010**

General and administrative	**$ 4,569**	$ 4,222	$ 4,063	8%	4%
As a percent of revenue	**6%**	6%	7%	0ppt	(1)ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense, severance expense, and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative personnel, certain taxes, and legal and other administrative fees.

Fiscal year 2012 compared with fiscal year 2011

General and administrative expenses increased, primarily due to a 10% increase in headcount-related expenses and a full year of Puerto Rican excise taxes, offset in part by a decrease in legal charges.

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Fiscal year 2011 compared with fiscal year 2010

General and administrative expenses increased, primarily due to a 12% increase in headcount-related expenses and new Puerto Rican excise taxes, partially offset by prior year transition expenses associated with the inception of the Yahoo! Commercial Agreement.

Goodwill Impairment

We conducted our annual goodwill impairment test as of May 1, 2012 for all reporting units. This test, which was based on our most recent cash flow forecast, indicated that OSD s carrying value exceeded its estimated fair value. Accordingly, we recorded a non-cash, non-tax deductible goodwill impairment charge of $6.2 billion during the three months ended June 30, 2012, reducing OSD s goodwill from $6.4 billion to $223 million.

OTHER INCOME (EXPENSE) AND INCOME TAXES

Other Income (Expense)

The components of other income (expense) were as follows:

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Dividends and interest income	**$ 800**	$ 900	$ 843
Interest expense	**(380)**	(295)	(151)
Net recognized gains on investments	**564**	439	348
Net losses on derivatives	**(364)**	(77)	(140)
Net gains (losses) on foreign currency remeasurements	**(117)**	(26)	1
Other	**1**	(31)	14
Total	**$ 504**	$ 910	$ 915

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedges are recognized in other income (expense). These are generally offset by unrealized gains and losses in the underlying securities in the investment portfolio and are recorded as a component of other comprehensive income.

Fiscal year 2012 compared with fiscal year 2011

Dividends and interest income decreased due to lower yields on our fixed-income investments, offset in part by higher average portfolio investment balances. Interest expense increased due to our increased issuance of debt in the prior year. Net recognized gains on investments increased, primarily due to higher gains on sales of equity and fixed-income securities and a gain recognized on the partial sale of our Facebook holding upon the initial public offering on May 18, 2012, offset in part by higher other-than-temporary impairments. Other-than-temporary impairments were $298 million in fiscal year 2012, compared with $80 million in fiscal year 2011. Net losses on derivatives increased due to losses on commodity and equity derivatives in the current fiscal year as compared with gains in the prior fiscal year, offset in part by fewer losses on foreign exchange contracts in the current fiscal year as compared to the prior fiscal year. Changes in foreign currency remeasurements were primarily due to currency movements net of our hedging activities.

Fiscal year 2011 compared with fiscal year 2010

Dividends and interest income increased due to higher average portfolio investment balances, offset in part by lower yields on our fixed-income investments. Interest expense increased due to our increased issuance of debt. Net

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recognized gains on investments increased, primarily due to higher gains on sales of equity securities, offset in part by fewer gains on sales of fixed-income securities. Derivative losses decreased, primarily due to higher gains on commodity derivatives offset in part by higher losses on currency contracts used to hedge foreign currency revenue.

Income Taxes

Fiscal year 2012 compared with fiscal year 2011

Our effective tax rates for fiscal years 2012 and 2011 were approximately 24% and 18%, respectively. Our effective tax rates were lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, which have lower income tax rates.

Our fiscal year 2012 effective rate increased by 6% from fiscal year 2011 mainly due to a nonrecurring $6.2 billion non-tax deductible goodwill impairment charge that was recorded in the fourth quarter of 2012. The goodwill impairment charge increased our effective tax rate by 10%. In addition, in fiscal years 2012 and 2011, we recognized a reduction of 21% and 16%, respectively, to the effective tax rate due to foreign earnings taxed at lower rates. In fiscal year 2011, we settled a portion of an I.R.S. audit of tax years 2004 to 2006, which reduced our income tax expense for fiscal year 2011 by $461 million and reduced the effective tax rate by 2%.

Changes in the mix of income before income taxes between the U.S. and foreign countries also impacted our effective tax rates and resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. As discussed above, Windows Division operating income declined $751 million in fiscal year 2012, while MBD and Server and Tools operating income increased $1.1 billion and $1.1 billion, respectively, during this same period. We supply Windows, our primary Windows Division product, to customers through our U.S. regional operating center, while we supply the Microsoft Office System, our primary MBD product, and our Server and Tools products to customers through our foreign regional operations centers. In fiscal years 2012 and 2011, our U.S. income before income taxes was $1.6 billion and $8.9 billion, respectively, and comprised 7% and 32%, respectively, of our income before income taxes. In fiscal years 2012 and 2011, the foreign income before income taxes was $20.7 billion and $19.2 billion, respectively, and comprised 93% and 68%, respectively, of our income before income taxes. The primary driver for the decrease in the U.S. income before income tax in fiscal year 2012 was the goodwill impairment charge.

Tax contingencies and other tax liabilities were $7.6 billion and $7.4 billion as of June 30, 2012 and 2011, respectively, and are included in other long-term liabilities. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for these years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2012, the primary unresolved issue relates to transfer pricing which could have a significant impact on our financial statements if not resolved favorably. We believe our allowances for tax contingencies are appropriate. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2011.

Fiscal year 2011 compared with fiscal year 2010

Our effective tax rates for fiscal years 2011 and 2010 were approximately 18% and 25%, respectively. Our effective tax rate was lower than the U.S. federal statutory rate and our prior year effective rate primarily due to a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, which have lower income tax rates. In fiscal years 2011 and 2010, our U.S. income before income taxes was $8.9 billion and $9.6 billion, respectively, and comprised 32% and 38%, respectively, of our income before income taxes. In fiscal years 2011 and 2010, the foreign income before income taxes was $19.2 billion and $15.4 billion, respectively, and comprised 68% and 62%, respectively, of our income before income taxes. In fiscal years 2011 and 2010, the reduction of the U.S. federal statutory rate as a result of foreign earnings taxed at lower rates was 16% and 12%, respectively.

In addition, our effective tax rate was lower than in the prior year due to a partial settlement with the I.R.S. in the third quarter of fiscal year 2011 relating to the audit of tax years 2004 to 2006. This partial settlement reduced our income tax expense for fiscal year 2011 by $461 million.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $63.0 billion as of June 30, 2012, compared with $52.8 billion as of June 30, 2011. Equity and other investments were $9.8 billion as of June 30, 2012, compared with $10.9 billion as of June 30, 2011. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities. While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of June 30, 2012 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We routinely monitor our financial exposure to both sovereign and non-sovereign borrowers and counterparties. Our gross exposures to our customers and investments in Portugal, Italy, Ireland, Greece, and Spain are individually and collectively not material.

Of the cash, cash equivalents, and short-term investments at June 30, 2012, approximately $54 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash and investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was approximately $660 million. As of June 30, 2012, approximately 77% of the short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 10% were invested in corporate notes and bonds of U.S. companies, and 3% were invested in U.S. mortgage-backed securities, all of which are denominated in U.S. dollars.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was $814 million as of June 30, 2012. Our average and maximum securities lending payable balances for the fiscal year were $1.2 billion and $1.4 billion, respectively. Intra-year variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

Valuation

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments, such as exchange-traded mutual funds, domestic and international equities, and U.S. treasuries. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government

bonds, mortgage-backed securities, and agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

A majority of our investments are priced by pricing vendors and are generally Level 1 or Level 2 investments as these vendors either provide a quoted market price in an active market or use observable inputs for their pricing without applying significant adjustments. Broker pricing is used mainly when a quoted price is not available, the investment is not priced by our pricing vendors, or when a broker price is more reflective of fair values in the market in which the investment trades. Our broker-priced investments are generally labeled as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all of our broker-priced investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments. Our fair value processes include controls that are designed to ensure appropriate fair values are recorded. These controls include model validation, review of key model inputs, analysis of period-over-period fluctuations, and independent recalculation of prices where appropriate.

Cash Flows

Fiscal year 2012 compared with fiscal year 2011

Cash flows from operations increased $4.6 billion during the current fiscal year to $31.6 billion due mainly to increased revenue and cash collections from customers. Cash used for financing increased $1.0 billion to $9.4 billion due mainly to a $6.0 billion net decrease in proceeds from issuances of debt and a $1.2 billion increase in dividends paid, offset in part by a $6.5 billion decrease in cash used for common stock repurchases. Cash used in investing increased $10.2 billion to $24.8 billion due mainly to a $10.0 billion increase in acquisitions of businesses and purchases of intangible assets and a $1.4 billion decrease in cash from securities lending activities, partially offset by a $1.2 billion decrease in cash used for net purchases, maturities, and sales of investments.

Fiscal year 2011 compared with fiscal year 2010

Cash flows from operations increased $2.9 billion during the current fiscal year to $27.0 billion due mainly to increased revenue and cash collections from customers. Cash used in financing decreased $4.9 billion to $8.4 billion due mainly to a $5.8 billion increase in proceeds from issuance of debt, net of repayments, offset in part by a $602 million increase in cash paid for dividends. Cash used in investing increased $3.3 billion to $14.6 billion due to a $5.8 billion increase in purchases of investments, offset in part by a $2.5 billion increase in cash from securities lending.

Debt

We issued debt in prior periods to take advantage of favorable pricing and liquidity in the debt markets, reflecting our credit rating and the low interest rate environment. The proceeds of these issuances were used to partially fund discretionary business acquisitions and share repurchases.

As of June 30, 2012, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $11.9 billion and $13.2 billion, respectively. This is compared with a carrying value and estimated fair value of $11.9 billion and $12.1 billion, respectively, as of June 30, 2011. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates and semi-annual interest record and payment dates were as follows as of June 30, 2012:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate	Interest Record Date	Interest Pay Date	Interest Record Date	Interest Pay Date
	(In millions)						
Notes							
September 27, 2013	$ 1,000	0.875%	1.000%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	3.049%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	1.795%	March 15	March 25	September 15	September 25
February 8, 2016	750	2.500%	2.642%	February 1	February 8	August 1	August 8
June 1, 2019	1,000	4.200%	4.379%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	3.137%	March 15	April 1	September 15	October 1
February 8, 2021	500	4.000%	4.082%	February 1	February 8	August 1	August 8
June 1, 2039	750	5.200%	5.240%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	4.567%	March 15	April 1	September 15	October 1
February 8, 2041	1,000	5.300%	5.361%	February 1	February 8	August 1	August 8
Total	10,750						
Convertible Debt							
June 15, 2013	1,250	0.000%	1.849%				
Total face value	$ 12,000						

As of June 30, 2012, the aggregate unamortized discount for our long-term debt, including the current portion, was $56 million.

Notes

The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Initially, each $1,000 principal amount of notes was convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share. The conversion ratio is adjusted periodically for dividends in excess of the initial dividend threshold as defined in the debt agreement. As of June 30, 2012, the net carrying amount of our convertible debt was $1.2 billion and the unamortized discount was $19 million.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft s common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock, or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of $1.24 billion were allocated between debt for $1.18 billion and stockholders equity for $58 million with the portion in stockholders equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to

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reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with an initial cap price equal to $37.16, which is adjusted periodically to mirror any adjustments to the conversion price. The purchased capped calls were valued at $40 million and recorded to stockholders equity.

Unearned Revenue

Unearned revenue at June 30, 2012 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at June 30, 2012 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions and prepaid points; the Windows Upgrade Offer; Microsoft Dynamics business solutions products; Skype prepaid credits and subscriptions; OEM minimum commitments; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of June 30, 2012:

(In millions)	
Three Months Ending,	
September 30, 2012	$ 6,874
December 31, 2012	5,635
March 31, 2013	4,323
June 30, 2013	1,821
Thereafter	1,406
Total	$ 20,059

Share Repurchases

On September 22, 2008, we announced that our Board of Directors approved a new share repurchase program authorizing up to $40.0 billion in share repurchases with an expiration date of September 30, 2013. As of June 30, 2012, approximately $8.2 billion remained of the $40.0 billion approved repurchase amount. The repurchase program may be suspended or discontinued at any time without notice.

During the periods reported, we repurchased with cash resources: 142 million shares for $4.0 billion during fiscal year 2012; 447 million shares for $11.5 billion during fiscal year 2011; and 380 million shares for $10.8 billion during fiscal year 2010.

Dividends

During fiscal years 2012 and 2011, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount (In millions)	Payment Date
Fiscal Year 2012				
September 20, 2011	**$ 0.20**	**November 17, 2011**	**$ 1,683**	**December 8, 2011**
December 14, 2011	**$ 0.20**	**February 16, 2012**	**$ 1,683**	**March 8, 2012**
March 13, 2012	**$ 0.20**	**May 17, 2012**	**$ 1,678**	**June 14, 2012**
June 13, 2012	**$ 0.20**	**August 16, 2012**	**$ 1,676**	**September 13, 2012**
Fiscal Year 2011				
September 21, 2010	$ 0.16	November 18, 2010	$ 1,363	December 9, 2010
December 15, 2010	$ 0.16	February 17, 2011	$ 1,349	March 10, 2011
March 14, 2011	$ 0.16	May 19, 2011	$ 1,350	June 9, 2011
June 15, 2011	$ 0.16	August 18, 2011	$ 1,341	September 8, 2011

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Off-Balance Sheet Arrangements

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating estimated losses on these indemnifications, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. To date, we have not encountered significant costs as a result of these obligations and have not accrued in our financial statements any liabilities related to these indemnifications.

Contractual Obligations

The following table summarizes the payments due by fiscal year for our outstanding contractual obligations as of June 30, 2012:

(In millions)	**2013**	**2014-2015**	**2016-2017**	**Thereafter**	**Total**
Long-term debt: [a]					
Principal payments	$ 1,250	$ 3,000	$ 2,500	$ 5,250	$ 12,000
Interest payments	344	616	491	3,457	4,908
Construction commitments [b]	353	0	0	0	353
Operating leases [c]	527	748	387	315	1,977
Purchase commitments [d]	6,556	884	236	146	7,822
Other long-term liabilities [e]	0	106	16	30	152
Total contractual obligations	$ 9,030	$ 5,354	$ 3,630	$ 9,198	$ 27,212

(a) *See Note 12 Debt of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).*

(b) *These amounts represent commitments for the construction of buildings, building improvements, and leasehold improvements.*

(c) *These amounts represent undiscounted future minimum rental commitments under noncancellable facilities leases.*

(d) *These amounts represent purchase commitments, including all open purchase orders and all contracts that are take-or-pay contracts that are not presented as construction commitments above.*

(e) *We have excluded long-term tax contingencies, other tax liabilities, and deferred income taxes of $9.5 billion and other long-term contingent liabilities of $220 million (related to the antitrust and unfair competition class action lawsuits) from the amounts presented, as the amounts that will be settled in cash are not known and the timing of any payments is uncertain. We have also excluded unearned revenue of $1.4 billion and non-cash items of $202 million.*

Other Planned Uses of Capital

On July 18, 2012, we acquired Yammer, Inc. (Yammer), a leading provider of enterprise social networks, for $1.2 billion in cash. Yammer will continue to develop its standalone service and will add an enterprise social networking service to Microsoft s portfolio of complementary cloud-based services.

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

Liquidity

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt repayment schedules, and material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future. In addition, we expect existing foreign cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our foreign operating activities and cash commitments for investing activities, such as material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

Should we require more capital in the U.S. than is generated by our operations domestically, for example to fund significant discretionary activities, such as business acquisitions and share repurchases, we could elect to repatriate future earnings from foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or dilution of our earnings. We have borrowed funds domestically and continue to believe we have the ability to do so at reasonable interest rates.

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

On July 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board (FASB) on disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll-forward activities on purchases, sales, issuances, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). Adoption of this new guidance did not have a material impact on our financial statements.

On January 1, 2012, we adopted guidance issued by the FASB on accounting and disclosure requirements related to fair value measurements. The guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the guidance expands the disclosures on Level 3 inputs by requiring quantitative disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. Adoption of this new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

In September 2011, the FASB issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The new guidance will be effective for us beginning July 1, 2012.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in stockholders equity. Instead, an entity will be required to present either a continuous statement of net income and

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other comprehensive income or in two separate but consecutive statements. This portion of the guidance will be effective for us beginning July 1, 2012 and will require financial statement presentation changes only. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. However, in December 2011, the FASB issued guidance that indefinitely defers the guidance related to the presentation of reclassification adjustments.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management s application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, goodwill, research and development costs, contingencies, income taxes, and stock-based compensation.

Revenue Recognition

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

Windows 7 revenue is subject to deferral as a result of the Windows Upgrade Offer, which started June 2, 2012. The offer provides significantly discounted rights to purchase Windows 8 Pro to qualifying end users that purchase Windows 7 PCs during the eligibility period. Microsoft is responsible for delivering Windows 8 Pro to the end customer. Accordingly, revenue related to the allocated discount for undelivered Windows 8 is deferred until it is delivered or the redemption period expires.

Impairment of Investment Securities

We review investments quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

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Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital.

The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results, market conditions, and other factors. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit.

Research and Development Costs

Costs incurred internally in researching and developing a computer software product are charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. Generally, this occurs shortly before the products are released to manufacturing. The amortization of these costs is included in cost of revenue over the estimated life of the products.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial statements.

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting literature also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense, net of estimated forfeitures, over the requisite service period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be impacted.

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STATEMENT OF MANAGEMENT S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management is responsible for the preparation of the consolidated financial statements and related information that are presented in this report. The consolidated financial statements, which include amounts based on management s estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America.

The Company designs and maintains accounting and internal control systems to provide reasonable assurance at reasonable cost that assets are safeguarded against loss from unauthorized use or disposition, and that the financial records are reliable for preparing financial statements and maintaining accountability for assets. These systems are augmented by written policies, an organizational structure providing division of responsibilities, careful selection and training of qualified personnel, and a program of internal audits.

The Company engaged Deloitte & Touche LLP, an independent registered public accounting firm, to audit and render an opinion on the consolidated financial statements and internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).

The Board of Directors, through its Audit Committee, consisting solely of independent directors of the Company, meets periodically with management, internal auditors, and our independent registered public accounting firm to ensure that each is meeting its responsibilities and to discuss matters concerning internal controls and financial reporting. Deloitte & Touche LLP and the internal auditors each have full and free access to the Audit Committee.

Steven A. Ballmer
Chief Executive Officer

Peter S. Klein
Chief Financial Officer

Frank H. Brod
Corporate Vice President, Finance and Administration;

Chief Accounting Officer

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign currency exchange rates, interest rates, credit risk, equity prices, and commodity prices. A portion of these risks is hedged, but they may impact our financial statements.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily and use hedges where practicable to offset the risks and maximize the economic effectiveness of our foreign currency positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar.

Interest Rate

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency and mortgage-backed securities.

Equity

Our equity portfolio consists of global, developed, and emerging market securities that are subject to market price risk. We manage the securities relative to certain global and domestic indices and expect their economic risk and return to correlate with these indices.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and facilitate portfolio diversification. Our investment portfolio has exposure to a variety of commodities, including precious metals, energy, and grain. We manage these exposures relative to global commodity indices and expect their economic risk and return to correlate with these indices.

VALUE-AT-RISK

We use a value-at-risk (VaR) model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with accounting principles generally accepted in the United States (U.S. GAAP), but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, and legal risk.

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The following table sets forth the one-day VaR for substantially all of our positions as of June 30, 2012 and June 30, 2011 and for the year ended June 30, 2012:

(In millions)

			Year Ended June 30, 2012		
Risk Categories	**June 30, 2012**	**June 30, 2011**	**Average**	**High**	**Low**
Foreign currency	**$ 98**	$ 86	**$ 173**	**$ 229**	**$ 84**
Interest rate	**$ 71**	$ 58	**$ 64**	**$ 73**	**$ 57**
Equity	**$ 205**	$ 212	**$ 194**	**$ 248**	**$ 165**
Commodity	**$ 18**	$ 28	**$ 20**	**$ 29**	**$ 15**

Total one-day VaR for the combined risk categories was $292 million at June 30, 2012 and $290 million at June 30, 2011. The total VaR is 26% less at June 30, 2012, and 25% less at June 30, 2011, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	**2012**	**2011**	**2010**
Revenue	**$ 73,723**	$ 69,943	$ 62,484
Operating expenses:			
Cost of revenue	**17,530**	15,577	12,395
Research and development	**9,811**	9,043	8,714
Sales and marketing	**13,857**	13,940	13,214
General and administrative	**4,569**	4,222	4,063
Goodwill impairment	**6,193**	0	0
Total operating expenses	**51,960**	42,782	38,386
Operating income	**21,763**	27,161	24,098
Other income	**504**	910	915
Income before income taxes	**22,267**	28,071	25,013
Provision for income taxes	**5,289**	4,921	6,253
Net income	**$ 16,978**	$ 23,150	$ 18,760
Earnings per share:			
Basic	**$ 2.02**	$ 2.73	$ 2.13
Diluted	**$ 2.00**	$ 2.69	$ 2.10
Weighted average shares outstanding:			
Basic	**8,396**	8,490	8,813
Diluted	**8,506**	8,593	8,927
Cash dividends declared per common share	**$ 0.80**	$ 0.64	$ 0.52

See accompanying notes.

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BALANCE SHEETS

(In millions)

June 30,	**2012**	**2011**
Assets		
Current assets:		
Cash and cash equivalents	**$ 6,938**	$ 9,610
Short-term investments (including securities loaned of **$785** and $1,181)	**56,102**	43,162
Total cash, cash equivalents, and short-term investments	**63,040**	52,772
Accounts receivable, net of allowance for doubtful accounts of **$389** and $333	**15,780**	14,987
Inventories	**1,137**	1,372
Deferred income taxes	**2,035**	2,467
Other	**3,092**	3,320
Total current assets	**85,084**	74,918
Property and equipment, net of accumulated depreciation of **$10,962** and $9,829	**8,269**	8,162
Equity and other investments	**9,776**	10,865
Goodwill	**13,452**	12,581
Intangible assets, net	**3,170**	744
Other long-term assets	**1,520**	1,434
Total assets	**$ 121,271**	$ 108,704
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 4,175**	$ 4,197
Current portion of long-term debt	**1,231**	0
Accrued compensation	**3,875**	3,575
Income taxes	**789**	580
Short-term unearned revenue	**18,653**	15,722
Securities lending payable	**814**	1,208
Other	**3,151**	3,492
Total current liabilities	**32,688**	28,774
Long-term debt	**10,713**	11,921
Long-term unearned revenue	**1,406**	1,398
Deferred income taxes	**1,893**	1,456
Other long-term liabilities	**8,208**	8,072
Total liabilities	**54,908**	51,621
Commitments and contingencies		

Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **8,381** and 8,376	**65,797**	63,415
Retained earnings (deficit), including accumulated other comprehensive income of **$1,422** and $1,863	**566**	(6,332)
Total stockholders equity	**66,363**	57,083
Total liabilities and stockholders equity	**$ 121,271**	$ 108,704

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Operations			
Net income	**$ 16,978**	$ 23,150	$ 18,760
Adjustments to reconcile net income to net cash from operations:			
Goodwill impairment	**6,193**	0	0
Depreciation, amortization, and other	**2,967**	2,766	2,673
Stock-based compensation expense	**2,244**	2,166	1,891
Net recognized gains on investments and derivatives	**(200)**	(362)	(208)
Excess tax benefits from stock-based compensation	**(93)**	(17)	(45)
Deferred income taxes	**954**	2	(220)
Deferral of unearned revenue	**36,104**	31,227	29,374
Recognition of unearned revenue	**(33,347)**	(28,935)	(28,813)
Changes in operating assets and liabilities:			
Accounts receivable	**(1,156)**	(1,451)	(2,238)
Inventories	**184**	(561)	(44)
Other current assets	**493**	(1,259)	464
Other long-term assets	**(248)**	62	(223)
Accounts payable	**(31)**	58	844
Other current liabilities	**410**	(1,146)	451
Other long-term liabilities	**174**	1,294	1,407
Net cash from operations	**31,626**	26,994	24,073
Financing			
Short-term debt repayments, maturities of 90 days or less, net	**0**	(186)	(991)
Proceeds from issuance of debt, maturities longer than 90 days	**0**	6,960	4,167
Repayments of debt, maturities longer than 90 days	**0**	(814)	(2,986)
Common stock issued	**1,913**	2,422	2,311
Common stock repurchased	**(5,029)**	(11,555)	(11,269)
Common stock cash dividends paid	**(6,385)**	(5,180)	(4,578)
Excess tax benefits from stock-based compensation	**93**	17	45
Other	**0**	(40)	10
Net cash used in financing	**(9,408)**	(8,376)	(13,291)
Investing			
Additions to property and equipment	**(2,305)**	(2,355)	(1,977)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(10,112)**	(71)	(245)
Purchases of investments	**(57,250)**	(35,993)	(30,168)
Maturities of investments	**15,575**	6,897	7,453
Sales of investments	**29,700**	15,880	15,125

Securities lending payable	**(394)**	1,026	(1,502)
Net cash used in investing	**(24,786)**	(14,616)	(11,314)
Effect of exchange rates on cash and cash equivalents	**(104)**	103	(39)
Net change in cash and cash equivalents	**(2,672)**	4,105	(571)
Cash and cash equivalents, beginning of period	**9,610**	5,505	6,076
Cash and cash equivalents, end of period	**$ 6,938**	$ 9,610	$ 5,505

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Common stock and paid-in capital			
Balance, beginning of period	**$ 63,415**	$ 62,856	$ 62,382
Common stock issued	**1,924**	2,422	2,311
Common stock repurchased	**(1,714)**	(3,738)	(3,113)
Stock-based compensation expense	**2,244**	2,166	1,891
Stock-based compensation income tax deficiencies	**(75)**	(292)	(647)
Other, net	**3**	1	32
Balance, end of period	**65,797**	63,415	62,856
Retained earnings (deficit)			
Balance, beginning of period	**(6,332)**	(16,681)	(22,824)
Net income	**16,978**	23,150	18,760
Other comprehensive income:			
Net unrealized gains (losses) on derivatives	**255**	(627)	27
Net unrealized gains (losses) on investments	**(390)**	1,054	265
Translation adjustments and other	**(306)**	381	(206)
Comprehensive income	**16,537**	23,958	18,846
Common stock cash dividends	**(6,721)**	(5,394)	(4,547)
Common stock repurchased	**(2,918)**	(8,215)	(8,156)
Balance, end of period	**566**	(6,332)	(16,681)
Total stockholders equity	**$ 66,363**	$ 57,083	$ 46,175

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP).

Principles of Consolidation

The financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments through which we exercise significant influence over but do not control the investee and are not the primary beneficiary of the investee s activities are accounted for using the equity method. Investments through which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples of estimates include: loss contingencies; product warranties; the fair value of, and/or potential goodwill impairment for, our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; allowances for product returns; and stock-based compensation forfeiture rates. Examples of assumptions include: the elements comprising a software arrangement, including the distinction between upgrades or enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management s estimates and assumptions.

Foreign Currencies

Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the year. Translation adjustments resulting from this process are recorded to Other Comprehensive Income (OCI).

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. Revenue generally is recognized net of allowances for returns and any taxes collected from customers and subsequently remitted to governmental authorities.

Revenue for retail packaged products, products licensed to original equipment manufacturers (OEMs), and perpetual licenses under certain volume licensing programs generally is recognized as products are shipped or made available. Revenue for products under technology guarantee programs, which provide free or significantly discounted rights to use upcoming new versions of a software product if an end user licenses existing versions of the product during the eligibility period, is allocated between existing product and the new product, and revenue allocated to the new product is deferred until that version is delivered. The revenue allocation is based on vendor-specific objective evidence of fair value of the products.

Certain multi-year licensing arrangements include a perpetual license for current products combined with rights to receive future versions of software products on a when-and-if-available basis (Software Assurance) and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the billing coverage period. Revenue from certain arrangements that allow for the use of a product or service over a period of time without taking possession of software are also accounted for as subscriptions. Revenue for software products where customers have the right to receive unspecified upgrades/enhancements on a when-and-if-available basis and for which vendor-specific objective evidence of fair value does not exist for the upgrades/enhancements is recognized on a straight-line basis over the estimated life of the software.

Revenue related to our Xbox 360 gaming and entertainment console, Kinect for Xbox 360, games published by us, and other hardware components is generally recognized when ownership is transferred to the resellers. Revenue related to games published by third parties for use on the Xbox 360 platform is recognized when games are manufactured by the game publishers.

Display advertising revenue is recognized as advertisements are displayed. Search advertising revenue is recognized when the ad appears in the search results or when the action necessary to earn the revenue has been completed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period. Consulting revenue for fixed-price services arrangements is recognized as services are provided. Revenue from prepaid points redeemable for the purchase of software or services is recognized upon redemption of the points and delivery of the software or services.

Cost of Revenue

Cost of revenue includes; manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our websites, and to acquire online advertising space (traffic acquisition costs); costs incurred to support and maintain Internet-based products and services, including royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs. Capitalized research and development costs are amortized over the estimated lives of the products.

Product Warranty

We provide for the estimated costs of fulfilling our obligations under hardware and software warranties at the time the related revenue is recognized. For hardware warranties, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and the country in which we do business, but generally include parts and labor over a period generally ranging from 90 days to three years. For software warranties, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Research and Development

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Such costs related to software development are included in research and development expense until the point that technological feasibility is reached, which for our software products, is generally shortly before the products are released to manufacturing. Once technological feasibility is reached, such costs are capitalized and amortized to cost of revenue over the estimated lives of the products.

Sales and Marketing

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel, and the costs of advertising, promotions, trade shows, seminars, and other programs. Advertising costs are expensed as incurred. Advertising expense was $1.6 billion, $1.9 billion, and $1.6 billion in fiscal years 2012, 2011, and 2010, respectively.

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Stock-Based Compensation

We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award (generally four to five years) using the straight-line method.

Employee Stock Purchase Plan

Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value of the stock on the last day of each three-month period. Compensation expense for the employee stock purchase plan is measured as the discount the employee is entitled to upon purchase and is recognized in the period of purchase.

Income Taxes

Income tax expense includes U.S. and international income taxes, the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested, and interest and penalties on uncertain tax positions. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. Deferred tax assets are reported net of a valuation allowance when it is more likely than not that a tax benefit will not be realized. The deferred income taxes are classified as current or long-term based on the classification of the related asset or liability.

Fair Value Measurements

We account for certain assets and liabilities at fair value. The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1 inputs are based upon unadjusted quoted prices for identical instruments traded in active markets. Our Level 1 non-derivative investments primarily include U.S. treasuries, domestic and international equities, and actively traded mutual funds. Our Level 1 derivative assets and liabilities include those actively traded on exchanges.

Level 2 inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, mortgage-backed securities, agency securities, certificates of deposit, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.

Level 3 inputs are generally unobservable and typically reflect management s estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets primarily comprise investments in certain corporate bonds and goodwill when it is recorded at fair value due to an impairment charge. We value the Level 3 corporate bonds using internally developed valuation models, inputs to which include interest rate curves, credit spreads, stock prices, and volatilities.

Our Level 3 derivative assets and liabilities primarily comprise derivatives for foreign equities. In certain cases, market-based observable inputs are not available and we use management judgment to develop assumptions to determine fair value for these derivatives. Unobservable inputs used in all of these models are significant to the fair values of the assets and liabilities.

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We measure certain assets, including our cost and equity method investments, at fair value on a nonrecurring basis when they are deemed to be other-than-temporarily impaired. The fair values of these investments are determined based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections. An impairment charge is recorded when the cost of the investment exceeds its fair value and this condition is determined to be other-than-temporary.

Our other current financial assets and our current financial liabilities have fair values that approximate their carrying values.

Financial Instruments

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. The fair values of these investments approximate their carrying values. In general, investments with original maturities of greater than three months and remaining maturities of less than one year are classified as short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash equivalents and short-term investments are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in market value, excluding other-than-temporary impairments, are reflected in OCI.

Equity and other investments classified as long-term include both debt and equity instruments. Debt and publicly-traded equity securities are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in market value, excluding other-than-temporary impairments, are reflected in OCI. Common and preferred stock and other investments that are restricted for more than one year or are not publicly traded are recorded at cost or using the equity method.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. Fair value is calculated based on publicly available market information or other estimates determined by management. We employ a systematic methodology on a quarterly basis that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established.

Derivative instruments are recognized as either assets or liabilities and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

For derivative instruments designated as fair-value hedges, the gain (loss) is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged items attributed to the risk being hedged. For options designated as fair-value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings.

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For derivative instruments designated as cash-flow hedges, the effective portion of the derivative s gain (loss) is initially reported as a component of OCI and is subsequently recognized in earnings when the hedged exposure is recognized in earnings. For options designated as cash-flow hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings. Gains (losses) on derivatives representing either hedge components excluded from the assessment of effectiveness or hedge ineffectiveness are recognized in earnings.

For derivative instruments that are not designated as hedges, gains (losses) from changes in fair values are primarily recognized in other income (expense). Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from OCI into other income (expense).

Allowance for Doubtful Accounts

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence. Activity in the allowance for doubtful accounts was as follows:

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Balance, beginning of period	**$ 333**	$ 375	$ 451
Charged to costs and other	**115**	14	45
Write-offs	**(59)**	(56)	(121)
Balance, end of period	**$ 389**	$ 333	$ 375

Inventories

Inventories are stated at the lower of cost or market, using the average cost method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term. The estimated useful lives of our property and equipment are generally as follows: computer software developed or acquired for internal use, three years; computer equipment, two to three years; buildings and improvements, five to 15 years; leasehold improvements, two to 10 years; and furniture and equipment, one to five years. Land is not depreciated.

Goodwill

Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value.

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Intangible Assets

All of our intangible assets are subject to amortization and are amortized using the straight-line method over their estimated period of benefit, ranging from one to 15 years. We evaluate the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired.

Recent Accounting Guidance

Recently adopted accounting guidance

On July 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board (FASB) on disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll-forward activities on purchases, sales, issuances, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). Adoption of this new guidance did not have a material impact on our financial statements.

On January 1, 2012, we adopted guidance issued by the FASB on accounting and disclosure requirements related to fair value measurements. The guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the guidance expands the disclosures on Level 3 inputs by requiring quantitative disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. Adoption of this new guidance did not have a material impact on our financial statements.

Recent accounting guidance not yet adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

In September 2011, the FASB issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The new guidance will be effective for us beginning July 1, 2012.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in stockholders equity. Instead, an entity will be required to present either a continuous statement of net income and other comprehensive income or in two separate but consecutive statements. This portion of the guidance will be effective for us beginning July 1, 2012 and will require financial statement presentation changes only. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. However, in December 2011, the FASB issued guidance which indefinitely defers the guidance related to the presentation of reclassification adjustments.

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NOTE 2 EARNINGS PER SHARE

Basic earnings per share (EPS) is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted EPS is computed based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, stock awards, and shared performance stock awards. The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)

Year Ended June 30,	2012	2011	2010
Net income available for common shareholders (A)	**$ 16,978**	$ 23,150	$ 18,760
Weighted average outstanding shares of common stock (B)	**8,396**	8,490	8,813
Dilutive effect of stock-based awards	**110**	103	114
Common stock and common stock equivalents (C)	**8,506**	8,593	8,927
Earnings Per Share			
Basic (A/B)	**$ 2.02**	$ 2.73	$ 2.13
Diluted (A/C)	**$ 2.00**	$ 2.69	$ 2.10

We excluded the following shares underlying stock-based awards from the calculations of diluted EPS because their inclusion would have been anti-dilutive:

(In millions)

Year Ended June 30,	2012	2011	2010
Shares excluded from calculations of diluted EPS	**1**	21	28

In June 2010, we issued $1.25 billion of zero-coupon debt securities that are convertible into shares of our common stock if certain conditions are met. As of June 30, 2012, none of these securities had met price or other conditions that would make them eligible for conversion and therefore were excluded from the calculation of basic and diluted EPS. See Note 12 Debt for additional information.

NOTE 3 OTHER INCOME (EXPENSE)

The components of other income (expense) were as follows:

(In millions)

Year Ended June 30,	2012	2011	2010
Dividends and interest income	**$ 800**	$ 900	$ 843
Interest expense	**(380)**	(295)	(151)
Net recognized gains on investments	**564**	439	348
Net losses on derivatives	**(364)**	(77)	(140)
Net gains (losses) on foreign currency remeasurements	**(117)**	(26)	1
Other	**1**	(31)	14
Total	**$ 504**	$ 910	$ 915

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Following are details of net recognized gains on investments during the periods reported:

(In millions)

Year Ended June 30,	2012	2011	2010
Other-than-temporary impairments of investments	$ (298)	$ (80)	$ (69)
Realized gains from sales of available-for-sale securities	1,418	734	605
Realized losses from sales of available-for-sale securities	(556)	(215)	(188)
Total	$ 564	$ 439	$ 348

NOTE 4   INVESTMENTS

Investment Components

The components of investments, including associated derivatives, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2012							
Cash	$ 2,019	$ 0	$ 0	$ 2,019	$ 2,019	$ 0	$ 0
Mutual funds	820	0	0	820	820	0	0
Commercial paper	96	0	0	96	96	0	0
Certificates of deposit	744	0	0	744	342	402	0
U.S. government and agency securities	47,178	130	(2)	47,306	561	46,745	0
Foreign government bonds	1,741	18	(29)	1,730	575	1,155	0
Mortgage-backed securities	1,816	82	(2)	1,896	0	1,896	0
Corporate notes and bonds	7,799	224	(15)	8,008	2,525	5,483	0
Municipal securities	358	58	0	416	0	416	0
Common and preferred stock	6,965	2,204	(436)	8,733	0	0	8,733
Other investments	1,048	0	0	1,048	0	5	1,043
Total	$ 70,584	$ 2,716	$ (484)	$ 72,816	$ 6,938	$ 56,102	$ 9,776

(In millions)	Cost Basis	Unrealized	Unrealized	Recorded	Cash	Short-term	Equity

		Gains	Losses	Basis	and Cash Equivalents	Investments	and Other Investments
June 30, 2011							
Cash	$ 1,648	$ 0	$ 0	$ 1,648	$ 1,648	$ 0	$ 0
Mutual funds	1,752	0	0	1,752	1,752	0	0
Commercial paper	639	0	0	639	414	225	0
Certificates of deposit	598	0	0	598	372	226	0
U.S. government and agency securities	33,607	162	(7)	33,762	2,049	31,713	0
Foreign government bonds	658	11	(2)	667	0	667	0
Mortgage-backed securities	2,307	121	(4)	2,424	0	2,424	0
Corporate notes and bonds	10,575	260	(11)	10,824	3,375	7,449	0
Municipal securities	441	15	(2)	454	0	454	0
Common and preferred stock	7,925	2,483	(193)	10,215	0	0	10,215
Other investments	654	0	0	654	0	4	650
Total	$ 60,804	$ 3,052	$ (219)	$ 63,637	$ 9,610	$ 43,162	$ 10,865

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Unrealized Losses on Investments

Investments with continuous unrealized losses for less than 12 months and 12 months or greater and their related fair values were as follows:

	Less than 12 Months		12 Months or Greater			Total
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
June 30, 2012						
U.S. government and agency securities	**$ 44**	**$ (2)**	**$ 0**	**$ 0**	**$ 44**	**$ (2)**
Foreign government bonds	**657**	**(27)**	**12**	**(2)**	**669**	**(29)**
Mortgage-backed securities	**53**	**0**	**48**	**(2)**	**101**	**(2)**
Corporate notes and bonds	**640**	**(11)**	**70**	**(4)**	**710**	**(15)**
Common and preferred stock	**2,135**	**(329)**	**305**	**(107)**	**2,440**	**(436)**
Total	**$ 3,529**	**$ (369)**	**$ 435**	**$ (115)**	**$ 3,964**	**$ (484)**

	Less than 12 Months		12 Months or Greater			
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2011						
U.S. government and agency securities	$ 484	$ (7)	$ 0	$ 0	$ 484	$ (7)
Foreign government bonds	365	(2)	0	0	365	(2)
Mortgage-backed securities	63	(3)	14	(1)	77	(4)
Corporate notes and bonds	750	(10)	25	(1)	775	(11)
Municipal securities	79	(2)	0	0	79	(2)
Common and preferred stock	1,377	(146)	206	(47)	1,583	(193)
Total	$ 3,118	$ (170)	$ 245	$ (49)	$ 3,363	$ (219)

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of June 30, 2012.

At June 30, 2012 and 2011, the recorded bases of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $313 million and $334 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not possible for us to reliably estimate the fair value of these investments.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
June 30, 2012		
Due in one year or less	$ 23,097	$ 23,125
Due after one year through five years	31,029	31,124
Due after five years through 10 years	3,173	3,371
Due after 10 years	2,433	2,576
Total	$ 59,732	$ 60,196

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NOTE 5 DERIVATIVES

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible. Our derivative programs include strategies that both qualify and do not qualify for hedge accounting treatment. All notional amounts presented below are measured in U.S. currency equivalents.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of June 30, 2012 and June 30, 2011, the total notional amounts of these foreign exchange contracts sold were $6.7 billion and $10.6 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of June 30, 2012 and June 30, 2011, the total notional amounts of these foreign exchange contracts sold were $1.3 billion and $572 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of June 30, 2012, the total notional amounts of these foreign exchange contracts purchased and sold were $3.6 billion and $7.3 billion, respectively. As of June 30, 2011, the total notional amounts of these foreign exchange contracts purchased and sold were $4.3 billion and $7.1 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of June 30, 2012, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.4 billion and $982 million, respectively. As of June 30, 2011, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.1 billion and $860 million, respectively.

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of June 30, 2012, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.2 billion and $1.9 billion, respectively. As of June 30, 2011, the total notional amounts of fixed-interest rate contracts purchased and sold were $2.3 billion and $697 million, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of June 30, 2012 and 2011, the total notional derivative amount of mortgage contracts purchased were $1.1 billion and $868 million, respectively.

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Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low cost method of managing exposure to individual credit risks or groups of credit risks. As of June 30, 2012, the total notional amounts of credit contracts purchased and sold were $318 million and $456 million, respectively. As of June 30, 2011, the total notional amounts of credit contracts purchased and sold were $532 million and $281 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap, futures, and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of June 30, 2012, the total notional amounts of commodity contracts purchased and sold were $1.5 billion and $445 million, respectively. As of June 30, 2011, the total notional amounts of commodity contracts purchased and sold were $1.9 billion and $502 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain a minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of June 30, 2012, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

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Fair Values of Derivative Instruments

The following tables present the gross fair values of derivative instruments designated as hedging instruments (designated hedge derivatives) and not designated as hedging instruments (non-designated hedge derivatives). The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
June 30, 2012						
Assets						
Non-designated hedge derivatives:						
Short-term investments	**$ 14**	**$ 162**	**$ 10**	**$ 26**	**$ 3**	**$ 215**
Other current assets	**85**	**0**	**0**	**0**	**0**	**85**
Total	**$ 99**	**$ 162**	**$ 10**	**$ 26**	**$ 3**	**$ 300**
Designated hedge derivatives:						
Short-term investments	**$ 6**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 6**
Other current assets	**177**	**0**	**0**	**0**	**0**	**177**
Total	**$ 183**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 183**
Total assets	**$ 282**	**$ 162**	**$ 10**	**$ 26**	**$ 3**	**$ 483**
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	**$ (84)**	**$ (19)**	**$ (17)**	**$ (21)**	**$ 0**	**$ (141)**
Designated hedge derivatives:						
Other current liabilities	**$ (14)**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ (14)**
Total liabilities	**$ (98)**	**$ (19)**	**$ (17)**	**$ (21)**	**$ 0**	**$ (155)**

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives

June 30, 2011

Assets

Non-designated hedge derivatives:						
Short-term investments	$ 14	$ 179	$ 0	$ 17	$ 4	$ 214
Other current assets	73	0	0	0	0	73
Total	$ 87	$ 179	$ 0	$ 17	$ 4	$ 287
Designated hedge derivatives:						
Short-term investments	$ 6	$ 0	$ 0	$ 0	$ 0	$ 6
Other current assets	123	0	0	0	0	123
Total	$ 129	$ 0	$ 0	$ 0	$ 0	$ 129
Total assets	$ 216	$ 179	$ 0	$ 17	$ 4	$ 416

Liabilities

Non-designated hedge derivatives:						
Other current liabilities	$ (91)	$ (12)	$ (9)	$ (19)	$ (4)	$ (135)
Designated hedge derivatives:						
Other current liabilities	$ (128)	$ 0	$ 0	$ 0	$ 0	$ (128)
Total liabilities	$ (219)	$ (12)	$ (9)	$ (19)	$ (4)	$ (263)

See also Note 4 Investments and Note 6 Fair Value Measurements.

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Fair Value Hedge Gains (Losses)

We recognized in other income (expense) the following gains (losses) on contracts designated as fair value hedges and their related hedged items:

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Foreign Exchange Contracts			
Derivatives	**$ 52**	$ (92)	$ (57)
Hedged items	**(50)**	85	60
Total	**$ 2**	$ (7)	$ 3

Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the periods presented):

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Effective Portion			
Gain (loss) recognized in OCI, net of tax effect of **$127,** $(340) and $188	**$ 236**	$ (632)	$ 349
Gain (loss) reclassified from OCI into revenue	**$ (27)**	$ (7)	$ 495
Amount Excluded from Effectiveness Assessment and Ineffective Portion			
Loss recognized in other income (expense)	**$ (231)**	$ (276)	$ (174)

We estimate that $137 million of net derivative gains included in OCI at June 30, 2012 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during fiscal year 2012.

Non-Designated Derivative Gains (Losses)

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), which were immaterial for the periods presented. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)

Year Ended June 30,	**2012**	**2011**	**2010**
Foreign exchange contracts	**$ (119)**	$ (27)	$ 106
Equity contracts	**(85)**	35	12
Interest-rate contracts	**93**	19	(4)
Credit contracts	**(7)**	24	22
Commodity contracts	**(121)**	148	(1)
Total	**$ (239)**	$ 199	$ 135

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NOTE 6   FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the fair value of our financial instruments that are measured at fair value on a recurring basis:

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2012						
Assets						
Mutual funds	$ 820	$ 0	$ 0	$ 820	$ 0	$ 820
Commercial paper	0	96	0	96	0	96
Certificates of deposit	0	744	0	744	0	744
U.S. government and agency securities	42,291	5,019	0	47,310	0	47,310
Foreign government bonds	31	1,703	0	1,734	0	1,734
Mortgage-backed securities	0	1,892	0	1,892	0	1,892
Corporate notes and bonds	0	7,839	9	7,848	0	7,848
Municipal securities	0	416	0	416	0	416
Common and preferred stock	7,539	877	5	8,421	0	8,421
Derivatives	16	467	0	483	(141)	342
Total	$ 50,697	$ 19,053	$ 14	$ 69,764	$ (141)	$ 69,623
Liabilities						
Derivatives and other	$ 10	$ 145	$ 0	$ 155	$ (139)	$ 16

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2011						
Assets						
Mutual funds	$ 1,752	$ 0	$ 0	$ 1,752	$ 0	$ 1,752
Commercial paper	0	639	0	639	0	639
Certificates of deposit	0	598	0	598	0	598

U.S. government and agency securities	23,591	10,175	0	33,766	0	33,766
Foreign government bonds	303	367	0	670	0	670
Mortgage-backed securities	0	2,428	0	2,428	0	2,428
Corporate notes and bonds	0	10,600	58	10,658	0	10,658
Municipal securities	0	454	0	454	0	454
Common and preferred stock	9,821	55	5	9,881	0	9,881
Derivatives	8	388	20	416	(204)	212
Total	$ 35,475	$ 25,704	$ 83	$ 61,262	$ (204)	$ 61,058
Liabilities						
Derivatives and other	$ 109	$ 257	$ 0	$ 366	$ (203)	$ 163

(a) *These amounts represent the impact of netting derivative assets and derivative liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk.*

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The following table reconciles the total Net Fair Value of assets above to the balance sheet presentation of these same assets in Note 4 Investments.

(In millions) June 30,	2012	2011
Net fair value of assets measured at fair value on a recurring basis	**$ 69,623**	$ 61,058
Cash	**2,019**	1,648
Common and preferred stock measured at fair value on a nonrecurring basis	**313**	334
Other investments measured at fair value on a nonrecurring basis	**1,043**	650
Less derivative assets classified as other current assets	**(185)**	(54)
Other	**3**	1
Recorded basis of investment components	**$ 72,816**	$ 63,637

Changes in Financial Instruments Measured at Level 3 Fair Value on a Recurring Basis

The following tables present the changes during the periods presented in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in OCI.

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Year Ended June 30, 2012				
Balance, beginning of period	**$ 58**	**$ 5**	**$ 20**	**$ 83**
Total realized and unrealized losses:				
Included in other income (expense)	**0**	**0**	**(5)**	**(5)**
Included in other comprehensive income	**(21)**	**0**	**0**	**(21)**
Conversions of Level 3 instruments to Level 1 instruments	**(28)**	**0**	**(15)**	**(43)**
Balance, end of period	**$ 9**	**$ 5**	**$ 0**	**$ 14**
Change in unrealized gains included in other income (expense) related to assets held as of June 30, 2012	**$ 0**	**$ 0**	**$ 0**	**$ 0**

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Year Ended June 30, 2011				
Balance, beginning of period	$ 167	$ 5	$ 9	$ 181
Total realized and unrealized gains (losses):				
Included in other income (expense)	39	0	11	50
Included in other comprehensive income	(63)	0	0	(63)
Purchases, issuances and settlements	(85)	0	0	(85)
Balance, end of period	$ 58	$ 5	$ 20	$ 83
Change in unrealized gains included in other income (expense) related to assets held as of June 30, 2011	$ 6	$ 0	$ 11	$ 17

Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

During fiscal year 2012 and 2011, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

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PART II

Item 8

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)

June 30,	2012	2011
Raw materials	**$ 210**	$ 232
Work in process	**96**	56
Finished goods	**831**	1,084